

***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"***

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**Japanese Bankers Association**

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## Strengthening the Resilience of the Banking Sector

### I . General Comments

#### **○ Overarching Issues (Paragraphs 1-17, 60-64)**

##### ○ 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.

- ✧ Around the world, banks are facing economic conditions that are far from robust. The imposition of numerous rules and regulations that would amplify procyclicality should be avoided at all costs. In addition, while individual proposed rules may be theoretically rational, there is a risk that, cumulatively, these rules may destabilize the financial system ('cumulative effects'). 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. Therefore, any individual regulations must be introduced in a manner that eliminates mutual inconsistencies and be made after sufficient consideration to regulation interdependency and balance.
- ✧ New regulations must achieve a balance between costs and effects. Ensuring the stability of financial systems and preventing recurrence of a financial crisis will require an entire package of regulation and supervision, not merely stronger capital surcharges on financial institutions.
- ✧ The G20 has announced a stated intention to phase in new regulations by 2012, when financial conditions have improved and economic recovery has been assured. However, the markets will work to reflect the impact of the new regulations in advance, beginning with the draft for consultation published at the end of last year and as future regulations

are finalized this year. Unforeseen events may also occur. Grandfathering was clearly being addressed before the consultative document was released; however, its role became unclear after publication. This has in fact led to confusion in the markets.

- ✧ In addition, there is the potential for substantial harm to capital markets of each country. This is due to pressure to dispose of financial institution investments as deductions, as well as excessive pressure to repay instruments already issued as Tier 1 capital and Tier 2 capital.
- ✧ As noted in the G20 statement, new rules for market participants must not impede sound market development. It is therefore necessary to consider the timing of new regulations in each country/region or each market and introduce grandfathering provisions that are sufficiently long. Dialogue must be initiated with the markets to carefully assess the degree to which new regulations penetrate. New regulations must be feasible for financial institutions from practical points of view, and also acceptable to stakeholders such as investors and other market participants.
- ✧ In light of the issues raised above, the Japanese Bankers Association advocates that full and careful attention be paid in designing the framework and setting levels for regulations as a whole. The impact on national economies, financial markets, and bank management should be considered and sufficiently prudent steps should be taken to ensure that regulations are not excessive.

## ○ 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.

- ✧ The Basel Committee's debate on regulation must be consistent internationally in order to ensure balanced terms of competition, but the regulations may not be optimal for the financial and economic conditions of all G20 countries. New regulations should be unbiased vis-à-vis the variety of business models in different countries and those regulations may result in unforeseen outcomes in a real economy for some countries. Some countries will be unable to respond flexibly in such situations. Though globally-uniform regulations may be desirable, the business cycle is not uniform globally. New regulations should be introduced only after due consideration of timing and method of introduction, as conditions in each country are different.
- ✧ Accounting standards and tax systems differ from country to country. Therefore, it is

important to design new regulatory frameworks and maintain level playing fields in a substantial sense. We believe that it is possible for authorities in all countries to develop better and balanced regulations, sharing common regulatory objectives and basic principles while addressing differences in accounting and taxation systems of each country. Such differences, which we believe to be acceptable, may include, for example, assumptions with regard to capital regulatory adjustments.

- ✧ Steps should be taken to enhance disclosure in order to facilitate comparability. Better disclosure will also help to strengthen outside monitoring and gain market confidence.

### ○ 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.

- ✧ In the recent financial crisis, investment banks that relied heavily on market funding effectively failed, while commercial banks that were dependant mostly on highly-'sticky' deposits were able to avoid liquidity crises. Any new regulations should be based on this lesson and be sufficiently unbiased to address the risk profiles of different business models.
- ✧ Financial institutions have a wide variety of business models that reflect their own economies. Japan has a high tendency for stable savings, and Japanese bank's management generally seeks to use retail deposits to achieve steady growth over the medium and long term, even if profitability itself is not necessarily high.
- ✧ Furthermore, care should be taken to provide that Pillar 2 of the Basel II Framework fully functions to address differences among countries. In addition, there are differences among financial institution's organizational structures and legal system in each country. Regulations should work to ensure essential fairness by addressing these differences.

### ○ 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.

- ✧ The sudden implementation of comprehensive, fundamental reform may cause unexpected damage. An appropriate timetable based on a Quantitative Impact Study

(QIS) is necessary, but QIS is merely a quantitative study that does not incorporate psychological reaction of market participants. As noted in the G20 statement, there must be a sufficient transitional period and adequate and comprehensive grandfathering measures must be included in order to smoothly introduce the new rules to market participants. However, we also encourage opportunities to discuss flexible reviews of regulations should material and unforeseen issues emerge or in cases when regulations do not strengthen resilience.

- ✧ A feasible implementation schedule that addresses the impact of introduction should be planned for countries that seek transition to International Financial Reporting Standards (IFRS) or otherwise change their accounting standards.

#### ○ 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.

- ✧ QIS is one of the very few means to determine appropriate levels of regulation. We consider it inappropriate to end the comment period when the results are not known even in outline form. These proposals contain some rules that are difficult to understand, and therefore we ask for an extension of the comment period.
- ✧ In addition, if any new regulations may be stricter than those proposed in this draft, or if there is a possibility that new rules not found in the consultative document will be added, additional market consultation and dialogue among regulators and banks regarding the relevant rules should take place.
- ✧ In particular, specific proposals for additional requirements like contingent capital and write-down features are scheduled to be discussed in July this year. Concrete calibrations should be made only after appropriate consultation and the completion of the requisite QIS.

## II. Detailed Comments

### 1. Definition of Capital

#### ○ Liquidity Surcharge and/or Capital Surcharge (Paragraphs 46-49)

- ✓ 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.

- ✧ Additional capital and liquidity requirements for systemically-important financial institutions (large financial institutions) will reduce the efficiency of the system and induce competitive unfairness.
- ✧ Risks for major financial institutions can be mitigated by enhancing bankruptcy regimes (deposit insurance schemes, etc.), supervisory authority inspections, early remedial measures, and other preventative tools.
- ✧ These measures would be more efficient for the economy as a whole than imposing additional capital surcharges. Whether or not to impose a regulatory framework in combination with additional capital charges, minimum capital requirements and capital buffers should be studied in light of the degrees to which these systems and schemes are functioned in individual countries.

#### ○ Grandfathering (Paragraphs 10(59, 64, 84))

- ✓ Grandfathering provisions should be applied to any capital raisings under current standards up to the date when the new regulations are implemented.

- ✧ The consultation document does not clearly define the timing of grandfathering. This issue has already confused the funding market, with banks adopting a wait-and-see attitude, becoming reluctant to issue Tier 1 hybrid instruments, and restricting Tier 2 refinancing.
- ✧ While steps must be taken to ensure that revision of rules take effect quickly and to curb a rush of last-minute responses to the revisions, any rules that have not been finalized will be regarded as final if the release date of the proposed rules is regarded as the grandfathering base date. The implementation date of the new rules and the

grandfathering base date should be the same in order to avoid any confusion in the financial markets.

- ✧ Under grandfathering, transactions already executed at the time when new rules are implemented will be treated as they were before. The date of record should, therefore, be the date on which the new rules are enacted in order to avoid announcement risk and market confusion.
- ✧ Even after the final rules are published, the environment for raising funds may still be unsuitable, given the time required to develop new qualified instruments and prepare for issuance. Grandfathering should be considered to facilitate refinancing of existing capital instruments.

#### ○ Appropriate Transitional Measures

✓ 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.

- ✧ Capital instruments with terms already issued should, at the very least, remain in their current capital categories until maturity; perpetual instruments (without maturity) should be counted toward the same categories for approximately 10 years after new regulations are introduced or until the first call arrives.
- ✧ Preferred shares with a mandatory conversion clause are similar in nature to common stock and therefore transitional measures should apply, particularly after the end of 2012, and they should be allowed as Tier 1 common equity until the conversion to common stock. If this is not allowed, additional common equity must be raised before the deadline to convert to common stock. One must assume that the intent of these revisions is not to impair capital efficiency by forcing funding merely for regulatory purposes.

#### ○ Regulatory Minimum Capital Ratios (Paragraphs 68, 85)

- ✧ Designating a transition period and allowing for phased-in implementation sufficient for equity and capital markets to absorb the impact of the regulatory revisions should be the predominant rule.
- ✧ Further, additional Tier 1 capital should be allowed as a predominant component in order to absorb losses and diversify funding on a going concern basis. The timing and method for phasing this in should be determined in light of financial and economic circumstances and capital raising conditions in each country or region.
- ✧ Improving capital quality, strengthening risk coverage and introducing new liquidity

regulations represent a significant expansion of risk coverage compared to existing regulatory levels. The x, y, z ratios (Paragraph 85) should not be determined conservatively or uniformly without considering the correlations among capital adequacy, leverage, and liquidity rules as independent rules so that the overall package does not become inefficient. The individual levels of the ratios should therefore be verified carefully.

- ✧ It is not necessary to raise the minimum capital adequacy ratio if potential losses are adequately measured by a risk coverage requirement and capital quality for absorbing actual losses is strengthened. Raising this ratio excessively could lead to costs being transferred on to borrowers and the real economy, and therefore this issue should be fully considered based on the findings of QIS.
- ✧ Furthermore, these decisions must be made cautiously in light of expected market changes after new rules are introduced. We view that banks will face far greater difficulties if they try to raise capital from the markets with instruments that conform to the proposed rules.
- ✧ In short, the Basel Committee should make its decision only after fully surveying market participants—issuers, underwriting securities companies, and investors—with regard to the marketability of instruments that conform to the consultation paper.

#### ○ Loss Absorbency (Paragraphs 87-89)

- ✧ The opinion that Tier 1 and Tier 2 loss absorbency must be increased probably stems from recognition during the recent financial crisis that, at banks that continued essentially as gone concern following injections of public funds, losses were not absorbed by regulatory capital Tier 1 and Tier 2 securities, and those banks did not bear their due burden.
- ✧ We believe that the issue is not only the ability of capital to absorb losses. Rather, first a system to deal with financial institution bankruptcy must be established and the responsibility of shareholders must be clarified. Common share values of some US and European banks that received public fund did not even fall. In Japan, public funds can be legally deployed in the event of a financial crisis (under Deposit Insurance Law Article 102), but the legal structure is such that the recipient bank's capital can be decreased (Article 106 of the same law). In fact, Japan's Long-Term Credit Bank and Nippon Credit Bank, which both received sizeable injections of public funds, lost 100% of their capital.

## Tier 1 Capital (Paragraphs 67-68, 75-77, 89-11, 91)

### ○ Preferred Shares (Tier 1)

- ✧ Preferred shares classified as shareholders' capital as they are in Japan have loss absorption functions required as Tier 1 additional going concern capital. In Japan, the issuer has the discretion to suspend dividend payments of preferred shares, and the dividends are non-cumulative. Regardless of any conversion clause, half of the issued amount can be booked as capital reserve, while the remainder is considered as capital. Upon an ordinary resolution of the general shareholders' meeting, it is possible to allocate capital reserves to absorb losses.
- ✧ Such preferred shares will be able to absorb losses for going concern capital, so they should be categorized as Tier 1 additional going concern capital.

### ○ Additional Requirements (Contingent Capital, Write-down Features) (Paragraph 91)

- ✓ 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 markets 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.

- ✧ We understand that specific proposals for additional requirements such as contingent capital and write-down features are scheduled to be discussed in July 2010.
- ✧ According to the definitions of Tier 1 and Tier 2 in Paragraph 70, Tier 1 is defined as capital that can absorb losses under the assumption that operations are continuing (going concern), while Tier 2 capital can be used to absorb losses in the event of bankruptcy (gone concern).
- ✧ The roles of Tier 1 as going concern capital and Tier 2 as gone concern capital should be clearly distinguished. Tier 2 capital continues to have an important role as gone concern capital that can be used for the protection of depositors and other creditors in the event of bankruptcy. Priority should be placed to ensure that Tier 2 capital functions as loss absorption capital in the event of bankruptcy.

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○ Criteria for Tier 1 Additional Going-concern Capital: Convertible Capital Instruments and Instruments with Write-down Features (Paragraph 91)

- ✧ Debt capital instruments such as mandatory convertible capital instruments and instruments with write-down features will enhance loss absorption, and can become capital instruments as capital buffers. On the other hand, investors' needs and their perspective as fund providers should be fully examined. More specifically, sufficient transitional period should be established to allow funding markets to function stably after the market of the contingent capital (mandatory convertible capital instruments and instruments with write-down features) reaches a sufficient scale.
- ✧ Currently, bond investors are the main purchasers of Tier 1 hybrid capital instruments. We are concerned that many bond investors will be reluctant to purchase these capital instruments if convertible features and/or write down features are added.
- ✧ In addition, concerning banks' own capital structures, issuing costs for contingent capital should be lower than those for common equity. Otherwise, there are no incentives for such contingent capital. This is an issue of hierarchy for capital structures. Currently, it is not clear whether or not capital structure hierarchy will satisfy all needs because there is no consensus in the market to accept this contingent capital and there is a high degree of uncertainty. We therefore view that the design and introduction of contingent capital should be determined after full and prudent consideration of market preferences and acceptability.
- ✧ Even if mandatory conversion and write-down features are required for Tier 1 additional going-concern capital, the coupons of these instruments should be treated as losses for tax purposes.

○ Criteria for Tier 2 Capital: Convertible Capital Instruments and Instruments with Write-down Features (Paragraph 91)

- ✧ As noted in Paragraph 90, the role of Tier 2 capital is to absorb losses in the event of bankruptcy, and Tier 2 capital should not be used to absorb losses before bankruptcy. Therefore, convertible capital instruments and instruments with write-down features should be qualified as going concern capital and categorized as Tier 1 capital or other capital buffers
- ✧ If mandatory conversion or write-down features are required for Tier 2 capital, the conditions *for trigger points to absorb losses* should be different from those of Tier 1 additional going concern capital. The role of Tier 2 vis-à-vis gone concern capital should be clarified. In addition, concerning loss sharing among these capital criteria, they must be precisely designed so that hierarchy of regulatory capital components is properly structured.

- ◇ More specifically, when a bank goes into legal bankruptcy, Tier 2 capital will be used to absorb losses without mandatory conversion or write-down features. The mandatory conversion or write-down features will present a problem when a failed bank continues as a going concern in effect. Trigger points should be set in consideration of the resolution framework. In Japan, for instance, the trigger points should be the events where legal measures are applied to insolvent banks under Article 102, Paragraph 1, Item 1 and Item 2 of Deposit Insurance Law of Japan.
  
- Tier 2 Capital (Straight-line Amortization Requirement) (Paragraphs 78, 90-4)
  - ◇ The draft proposes to change the purpose of Tier 2 from supplemental capital to gone concern capital based on the event of bankruptcy. The term to maturity has no direct impact on the liquidation value in bankruptcy because Tier 2 capital is expected to absorb losses at the time of bankruptcy.
  - ◇ The draft states that "recognition in regulatory capital in the remaining 5 years before maturity will be amortised on a straight line basis.". However, in light of its nature as Tier 2 gone concern capital, as long as the loss-absorption capacity is recognized, we see no need for regulations to require straight-line amortization.
  
- Tier 2 Capital (Step-ups) (Paragraphs 90-4)
  - ◇ We request that Tier 2 capital with step-ups continue to be qualified as Tier 2 capital. The consultative document assumes that capital instruments with step-ups do not qualify as Tier 2 capital because of the high probability of redemption. However, these features should be clearly distinguished between other Tier 1 capital as going concern capital and Tier 2 capital as gone concern capital in the event of bankruptcy. As proposed in the consultative document, Tier 2 capital is defined as capital that can have maturities and can be redeemed. Therefore, redemption incentives due to step-ups should be considered as part of Tier 2 capital instruments which are designed to be redeemed.
  - ◇ We do not believe that it is necessary to require minimum call period before a call option can be exercised because Tier 2 capital functions as gone concern capital and a prior supervisory approval is required when a call is exercised.
  - ◇ In order to vary and maximize capital raising, it is important to keep developing an array of products that meet broad investor needs while maintaining Tier 2 functionality. Step-up interest-bearing products that meet investor needs and especially retail products with initial calls within five years should be considered as Tier 2 capital, just as they are treated under the current regulations. (In Japan, all retail subordinated bonds, a market size of JPY 2 trillion, have three-year calls.)

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### ○ Call Options (Paragraph 92)

- ✧ Call options in Tier 2 capital are needed to ensure flexibility for banks' own capital planning.
- ✧ We do not believe that call options worsen the quality of capital and capital instruments with call options will necessarily be redeemed. Recently there have been some cases that call options are not exercised in the capital markets. In addition, call options can be exercised only after receiving prior approvals from authorities. It is clearly stated that banks must maintain adequate capital and refinance capital instruments with equal or higher quality.

### ○ Regulatory Adjustments (Minority Interests) (Paragraph 95)

- ✧ Deducting the entire value of minority interests from common equity is inappropriate because minority interests can be used to absorb losses attributed to the relevant subsidiaries.
- ✧ It is unreasonable to include risk assets of relevant subsidiaries that correspond to minority interests in the denominator while deducting minority interests from the numerator. If minority interests are to be deducted from the numerator, then there must be a framework for deducting the risk assets of relevant subsidiaries that correspond to minority interests from the denominator.

### ○ Regulatory Adjustments (Other Comprehensive Income) (Paragraphs 85, 96)

- ✧ The consultative document states that other comprehensive income (OCI) will be included in common equity. They also state that unrealized losses will be reflected in common equity without any adjustments, but the treatment of unrealized profit will be considered later.
- ✧ If unrealized losses are reflected in common equity (without any adjustments), the rules should, at least, allow symmetric recognition of both unrealized gains and unrealized losses from the perspective of loss absorption. Large inconsistencies in loss absorption capacity of common equity will arise if the changes in OCI are directly linked to loss absorption capacity and only unrealized losses are reflected in common equity.
- ✧ Reflecting both unrealized gains and unrealized losses of OCI in common equity will have the same impact on common equity as on trading books, and this will reduce arbitrage due to the differences in treating unrealized gains/losses between the banking books and trading books.

○ Regulatory Adjustments(Other Intangible Assets-Software, etc.) (Paragraph 97)

✓ Software and other intangible assets that produce cash flows should not be deducted.

- ✧ In the consultative document, intangible fixed assets are treated as regulatory adjustments to common equity. This reflects the idea that intangible fixed assets cannot be liquidated.
- ✧ There are some tangible fixed assets that cannot be liquidated. Most bank assets comprise financial assets. However, most software assets, such as accounting and operating systems that are source of banks' cash flows, function as an integrated group of multiple assets to produce business cash flows. This is the case regardless of whether they are tangible or intangible. Therefore, the judgment should not be made whether assets are liquidatable, but whether they are important assets that produce business cash flows. We do not think it is appropriate for such assets to be excluded from going concern capital simply due to lack of liquidatability.
- ✧ Regardless of liquidatability, differences in accounting standards and development practices of software suggest that software is recorded as an intangible fixed asset in Japan, while in Europe and the US, software is recorded as a tangible fixed asset. It is , therefore unreasonable to test liquidity only when software is recorded as an intangible fixed asset.
- ✧ In Japan, most accounting and operating systems are developed internally and, for accounting purposes, software is recorded as an intangible fixed asset. Conversely, most European and U.S. banks purchase software as part of a hardware package from outside vendors and, for accounting purposes, software is recorded as a tangible fixed asset. It is inconsistent to deduct the full amount of intangible fixed assets from common equity without sufficiently understanding differences in the nature of intangible fixed assets, accounting treatments, and business practices. When considering adjustments, different definitions in different countries and different accounting standards must be fully considered; across-the-board deductions could potentially destabilize banks' operations.
- ✧ Leasing assets are considered as intangible fixed assets, but they are balanced by leasing liabilities and actually they are similar to acquisitions of fixed assets through borrowings. Therefore it is inappropriate for leasing assets to be excluded from common equity simply because they are classified as intangible assets.

○ Regulatory Adjustments (Deferred Tax Assets) (Paragraph 98)

✓ 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.

- ✧ For accounting purposes, deferred tax assets (DTA) are only recognized under going concern assumptions, and the value is reassessed every year according to the business circumstances of the financial institution. Therefore it is inappropriate to deduct DTA from common equity, which is going-concern capital. It is reasonable to include DTA in common equity because it is quite similar to retained earnings in nature.
- ✧ Deferred tax assets largely reflect the results from mismatches between financial and tax treatment, differences in treatment of tax refunds, accounting standards, tax regime of each country. There are significant mismatches between financial treatment and tax treatment in Japan and the U.S., and DTA tends to be larger in these countries. Taxation in Europe is based on accounting and, therefore, the mismatches between financial treatment and tax treatment are small, resulting with relatively small DTA. Consequently, the differences among accounting standards in different jurisdictions give rise to a lack of fairness and do not facilitate level playing field.
- ✧ On the other hand, the entire DTA should be included in common equity if the amounts recorded are assessed by an external auditor as realizable assets and are based on profit plans prepared in accordance with the accounting standards under the assumptions of considerable stress and appropriately adjusted to reflect back testing. If it is difficult to include the entire amount into common equity, under the Japanese accounting standards, for example, DTA can be usually recognized at least to the extent of the portion for one year even under circumstances where results are worse than expected. The exception for that treatment is the case where the decline in performance is so significant that it is impossible to rationally estimate taxable income, for example, large tax losses for 3 consecutive terms. Regulations should allow us to recognize reasonable amount of DTA for a highly predictable term.
- ✧ Even when treated without bias, deduction in full is considered excessive. Measures allowing inclusion up to a certain level of Tier 1 capital are possible (for example, a rule allowing up to 20 percent of Tier 1). It would also be appropriate to consider mismatches between financial treatment and tax treatment among countries given the fact that the global harmonization of tax regime is impossible.
- ✧ Accumulating allowances for credit losses without bias increases DTA, and therefore deducting the full amount of DTA will result in penalizing prudent banks. This creates inconsistency among regulations.

○ Regulatory Adjustments (Treasury Stock) (Paragraph 100)

- ✧ When a bank's own stock is included in an index fund, the bank does not intentionally hold it as treasury stock and its percentage of the portfolio is negligible. Deducting treasury stock in an index fund will merely result in heavy costs to capture the balance. Therefore, the treasury stock included in an index fund should be excluded from regulatory adjustments.
- ✧ Furthermore, capturing the balance of index funds held by consolidated subsidiaries and deducting these are unrealistic, because a large administrative burden is imposed vis-à-vis the extremely small effect.

○ Regulatory Adjustments (Double Gearing Rules) (Paragraph 101)

- ✓ 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 adjustments to investments in certain economic regions or investments in domestic financial institutions.

- ✧ Double gearing is an adjustment from the perspective of macro-prudence, not from the perspective of going concern of loss absorbency. In other words, double gearing is based on the idea that the stability of financial system as a whole will improve if financial institutions are required to raise capital from other sectors. Therefore, double gearing itself does not impair loss absorbency and should be discussed separately from going concern issues.
- ✧ Injections into multiple financial institutions in the same country or economic region could exacerbate the risk of a string of bankruptcies in the area. However, 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.
- ✧ In fact, in the recent financial crisis, capital from oil money from Middle Eastern countries and large Japanese financial institutions greatly reduced the risk of successive failures in the U.S. and Europe by allowing US and European banks to

avoid public injections and rescuing them from the crisis.

- ✧ Applying broadly double gearing rules including Materiality Rule, Aggregation Rule, Correspondence Rule to investments in financial institutions could undermine healthy incentives for expanding domestic and international operations through these investments. For example, many Asian countries have regulations that cover investments by foreign banks into local banks and financial institutions. (Limits on foreign capital investments are as follows: China 20%, India 5%, Vietnam 15-20%, Malaysia 20%, and Thailand 25%-49%) In these cases, there are large differences, in terms of regulatory capital, between capital requirements for risk asset investments and those subject to capital deduction under the Materiality Rule for investments exceeding 10% of the financial institution's common stock under double gearing rules. These rules would impair cross-border alliances and partnerships among commercial banks through minor currency investments. We, therefore, propose that all of these investments should be counted on a risk asset basis or by other measures which should be introduced to reduce such a large cliff effect.
- ✧ In regions with significant financial demand, this rule will discourage cross-border alliances and partnerships among commercial banks, which may hinder customer convenience and the development and intermediary functions of the financial markets.
- ✧ The scope of financial institutions to which the deductions will apply and the definition of reciprocal cross holding agreements should be carefully considered mainly because the scope and definition of business permitted for financial institutions depend on laws and regulations of each country. .
- ✧ Expanding the scope of double gearing in a quick manner could cause share prices to drop by cutting crossholdings, and this could cause confusion in the markets. Double gearing rules should be introduced cautiously, taking into account the lessons from the recent financial crisis and theoretical rationale, as well as the monetary policies of each country, funding structures of financial institutions, and long-term empirical analysis.
- ✧ We foresee substantial and numerous adverse impacts on capital adequacy at other financial institutions (external capital-raising ability) arising from deducting investments in financial institutions on trading books. This will substantially reduce the ability of risk-taking by securities companies in, for example, underwriting equities and impede sound market operations. Holdings that are used temporarily for underwriting or other reasons during trading activities, under appropriate risk management, should be excluded.
- ✧ In addition, as it is the case with treasury stock, it is unrealistic to capture securities from index funds that are subject to double gearing rules. The intention behind investments in index funds is to share risk across the entire equity market and to hedge risk by diversifying investments among issuers and sectors, not to invest in specific financial institutions. If such capital deductions apply only to financial institutions, the

balance of investments and mutual linkages from diversified investments would crumble. This would have a significant impact on the index fund markets. Furthermore, when the risk weights of index funds are calculated using the internal model method for equity exposures, the capital charge is counted twice. This is not appropriate for capturing risks.

○ Regulatory Adjustments (Excess Expected Losses) (Paragraphs 102, 103) (Paragraphs 102, 103)

✧ Deducting shortfalls in reserves against expected losses (EL) from common equity eliminates the incentive to under-reserve. In order to ensure sufficient incentive to reserve, the current ceiling (1.25% of credit risk assets under the standardized approach; 0.6% of credit risk assets under the internal ratings-based (IRB) approach) should be eliminated.

○ Regulatory Adjustments (Defined Benefit Pension Fund Assets and Liabilities) (Paragraphs 106, 107)

✓ 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.

✧ Accounting standards for post-employment benefits differ across countries and regions. Those differences must be fully addressed before implementation.

✧ IFRS is scheduled to apply in the Japanese accounting system in the future, and it is expected to eliminate accounting discrepancies. Recording full amount of the perspective shortfall in pension funds is being considered as part of convergence process before IFRS is introduced. Therefore, counting defined benefit pension fund assets as regulatory adjustments should be grandfathered (exempted) until IFRS applies or its convergence takes effect from the perspective of comparability across countries.

✧ The definition of prepaid pension expenses as a regulatory adjustment, for example, is inconsistent with the US practice of adjusting capital accounts by immediate recognition of pension liabilities (shortfalls in pension fund assets against retirement benefit obligations after adjustments for tax effects). If these are to be treated fairly, then the deductions should be from shortfalls in reserves against retirement benefit obligations after adjustments for tax effects, not from prepaid pension expenses.

- ✧ When equity securities account for a relatively high proportion of pension assets, they can be directly influenced by fluctuations in share prices. Consequently, when the regulatory adjustments are made from common equity, pension assets which are, in essence, long-term investments may amplify short-term cyclicity. In addition, due consideration is necessary for the phase-in mechanism in the introductory period of this rule because the overhaul of bank retirement benefit systems and reallocation of assets could have an adverse impact on equity markets that would impede economic recovery.
  
- Deducting the Remaining 50:50 (Paragraph 108)
  - ✧ Rather than the flat 1,250% risk weight based on the 8% capital standard, we view that posting a risk weight with a denominator calculated as  $(1/z\% * 100)$  % would be fairer to recognize risk assets depending on the levels of minimum capital ratios. We request that regulatory capital in excess of maximum possible losses not be required. In this context, "z" refers to the capital adequacy ratio proposed in Paragraph 85.
  
- Disclosure (Paragraph 109) (Paragraph 109)
  - ✧ It is sometimes difficult to disclose the full terms and conditions of all instruments included in regulatory capital from the viewpoint of the investors especially in case of private placements. The terms and conditions of the instruments should be disclosed as necessary, rather than fully, considering materiality.

## 2. Enhancing Risk Coverage

### ○ General Points

- ✧ The proposed regulations seek additional cumulative capital surcharges on transactions among financial institutions by raising risk weight levels in light of asset value correlations. These are above and beyond the expanded recognition of EAD for the market price risks of counterparty risk. We believe that some measures are necessary which address cumulative increases impact when levels of increased capital charge for individual proposals are set.
- ✧ We ask that consideration be paid to any adverse impact on the facilitation of corporate financing due to the excessive taxing on transactions that stems from corporate customer's real demand.
- ✧ The recent financial crisis had different impacts on banking and trading books. Regulations are already being reviewed for trading books, where the impact was largest. We question whether reviews on financial institution's asset value correlation are absolutely necessary in light of the significant impact this will have on banking books.
- ✧ With regard to the capital charge for credit valuation adjustment (CVA), amount and impact of losses being different among countries, risk asset calculation method and the timing of implementation must be designed to incorporate those differences.
- ✧ In addition, a number of issues to be examined with the proposed calculation methods have been identified and these issues should be reviewed through another consultation. It is important that sufficient number of consultations will be done before finalizing the rule.

### ○ Issues Regarding the Scope of CVA Capital Charges (Paragraphs 123-125)

- ✓ 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.

- ✧ OTC derivatives can be roughly classified into two types: hedges on enterprises' current transactions and active risk-taking instruments. Those hedges can be of interest-related Asset Liability Management, foreign exchange for export/import prices or for corporate credit exposures. We understand subjecting the latter type, i.e., active risk-taking instruments, to regulation because these instruments are subject to cancellation prior to

maturity and hedging. Conversely, for the former type, i.e., transactions for hedges normally remain in effect until maturity and there are in principle no early cancellations. This implies that although these transactions are booked in trading books for accounting purposes, they accompany credit risk..

- ✧ In particular, serving the hedging needs of corporations for transactions related to real demand for delivery of goods and/or services is one of the core functions of commercial banks. We believe that the measurement approach without distinguishing between such transactions and speculation and applies punitive capital charges to unrated corporations is extreme. The consultation document will have a substantially unfair impact on commercial banks involved in large corporate transactions. It is unnecessary to add CVA to the transactions relating to the delivery of goods and services with corporations. Therefore, these should be excluded from this regulation.
- ✧ In the recent financial crisis, credit standings of some financial institutions deteriorated, and the impact has spread rapidly throughout the financial system. On the other hand, the nature of corporate credit risk differs greatly from that of financial institution. While deterioration of corporate credit risk had an adverse effect gradually on the real economy, credit risk at financial institutions spread quickly in a chain reaction. In addition, transaction amounts with individual corporations are small and do not impact the viability of the financial institution. From this perspective as well, we understand why financial institutions are the target of this regulation and we believe that non-speculative transactions with corporations should be excluded.

#### ○ Measurement Method Issues

✓ 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.

- ✧ The formula presented in the current proposal is unclear, excessively conservative on several points, and needs to be modified to better reflect reality.
- ✧ Securities are priced at current market prices relative to credit spreads. However, specific risks are double-charged in gauging fluctuation, as it is the case with general market risks, the risk of change in non-risk interest rates.
- ✧ For example, with respect to bond maturities, the proposal is to use "the longest Effective Maturity across OTC derivative netting sets with this counterparty", but this is excessively conservative. We view that it will be sufficient to use average maturity weighted for exposure.
- ✧ Further, we request that the same type of cap for effective maturities be set as for credit risk.

- ✧ The CDS spread is released as a discount rate, but most markets around the world have no liquidity. Using this kind of metric to measure risk-weighted assets could destabilize minimum capital requirements.
- ✧ Financial institutions that use the standard measurement method for specific risks will be treated unfairly by the current proposal. This is because, by design, the standard measurement method overstates risk in comparison to internal models of specific risk where financial institutions using the models are allowed to exclude default risk.
- ✧ When credit spreads are used to calculate bond equivalent values to obligations, the CEM (Current Exposure Method) is disadvantageous because EAD cannot be adjusted for collateral. Therefore, there is a need to develop methods for treating collateral so that banks are neither advantaged nor disadvantaged depending on the selection.
- ✧ The proposed calculation imposes extremely high risk-weights on measured principal (equivalent values for obligations) because of added stress VaR and adjustments for holding periods. It is irrational for the highest risk weights or the unrated default risk weight to be applied regardless of the quality of the asset.
- ✧ In addition, different ratings are used for credit risk (internal ratings) as opposed to market risk (external ratings), but there has been no attempt to take into account the resultant impact. If internal ratings cannot be used for calculations under the market risk method (specific risk capital charge under standardized measurement method portion), enterprises that are considered excellent based on internal ratings are nonetheless treated as unrated entities simply because they have not issued bonds. As noted above, this means that default level risk weights must be used, which is inconsistent with credit risk.
- ✧ The document proposes to use the market risk capital framework as-is when using an internal models approach to calculate market risk equivalents of bond equivalent values. However, this requires calculating VaR for the most recent 60 business days and therefore daily updates of regulatory EAD values and CDS spreads, etc are required. This raises practical difficulties and requires large system investments. It would be more realistic to have a simplified approach, for example, "VaR from the calculation base date x Multiplier according to number of times exceeded."

#### ○ Alternative Proposal

- ✧ There has been inadequate study of the suitability of measurement methods toward market risk, and there are questions about consistency with the fundamental review of market risk measurement. We propose that the proposed market risk amendment to calculate full-scale CVA equivalents be postponed until the fundamental review of market risk. We also propose that, for the time being, the simplified measurement framework be substituted. This proposal has more merit than the proposal in the

consultation document because it reduces burdens;

- ✓ Measure capital requirements by establishing scaling factors for current counterparty credit risk.
- ✓ Scaling factors should be used for financial institutions (including hedge funds and investment trusts, etc.), while corporations and other entities that do not impact systemic risks for the financial system should be excluded.
- ✓ Scaling factors should be established with an emphasis on fairness so that differences in the approaches used to calculate market risk and credit risk (consideration of CSA collateral) do not result in disadvantages. If the proposed approach is introduced prior to the fundamental review of market risk measurement, we would seek an explicit commitment regarding treatment at the time of the fundamental review and burdens on the financial institutions.

#### ○ Large Financial Institution Asset Value Correlation (AVC) (Paragraph 135)

- ✧ Systemic risk should be addressed using a policy mix that includes liquidity regulations and central bank liquidity controls during times of crisis. It is inappropriate to, for example, hike and apply additional capital charges against asset value correlation (AVC) for inter-bank lending, which was not the direct factor in the emergence of systemic risk during the recent financial crisis.

#### ○ Definition of Financial Institutions (Paragraphs 135-139)

- ✧ AVC coefficients should be reviewed with caution using analytical findings with regard to counterparties that are shared by regulators and financial institutions. Financial institutions should not be focused at this time for Pillar 1. We believe that careful consideration should be given by both public and private levels to the need for such classification and regulation. This is because Pillar 1 does not address country / region / sector concentration risks nor individual counterparty concentration risk; these risks are addressed by Pillar 2. Furthermore, the findings and conclusions must be shared by public and private sectors.
- ✧ The rationale for setting threshold of 25 billion dollars in assets for asset value correlation (AVC) multipliers is unclear. We would also like to see evidence from the full assessment to support the necessity of additional capital charges in the domestic call market. The role of the domestic call market is to adjust financial institutions' deposit/lending structures and the market was not a direct factor in the crisis.
- ✧ We support efforts to develop a shared perception of asset value correlations by, for example, holding government and private sector meetings to discuss the review. We would also request a sufficiently long transition period, because the definitions differ

from existing asset classifications and considerable time will be required for systems development.

- ✧ It is difficult to categorize unregulated financial firms due to the nature of their businesses. We would like to see a clear definition that is suitable for an international comparative framework.

#### ○ Treatment of Highly-Leveraged Counterparties (Paragraph 164)

- ✧ The document discusses "counterparties that are highly leveraged or counterparties whose assets are predominantly traded assets," but we note that some small-and medium-sized enterprises are highly leveraged and hold large merchandise inventories. Therefore, those small-and medium-sized enterprises could fall under this definition. We encourage further study on a definition that is more limited in scope or the same as unregulated financial institutions in Paragraph 139. (If the new definition is the same as unregulated financial institutions, levels should be determined after taking into account the synergies from higher correlation multipliers and higher PDs).
- ✧ The document notes "PD estimates for highly leveraged counterparties should reflect the performance of their assets based on a stressed period," but there are problems with collecting information as well as technical issues related to estimations. We think that the feasibility of implementation should be studied by, for example, applying a flat multiplier for non-stressed PDs.

#### ○ Addressing Reliance on External Credit Ratings and Minimizing Cliff Effects (Paragraph 186)

- ✧ A structure to encourage disclosure of rating approaches and important data is necessary to improve the transparency of securitized instrument ratings. Bank credit risk models differ in reliability and data collection; this is particularly true for securitized instruments, which must rely on external ratings. To supplement this, major risk analysis data and rating approaches should be disclosed to ratings agencies and supervisory authorities.

### 3. Leverage Ratio

#### ○ The Positioning of Leverage Ratio Regulations (Paragraphs 202-207)

- ✓ 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.

- ✧ Leverage ratio regulations should encourage lower ratios during stable times and should not be linked excessively to unwinding leverages. We encourage designing regulations so that their supervisory purposes are not impaired.
- ✧ Leverage ratio and liquidity regulations mutually interact, but they are appropriate as uniform international levels for management in Pillar 2. This is not only because there are no absolute leverage ratio levels, but also because the degrees of importance differ among different countries in regard to accounting systems, deposit insurance systems, and indirect finance, as well as differences in business models. We therefore view that leverage ratio should be addressed in a manner appropriate to the circumstances of individual countries as explained below, rather than as uniform, global regulations that will later be moved to the Pillar 1.
  - This ratio will depend, to a great extent, on national accounting standards and capital markets as well as balance sheet characteristics. As a result, there are significant differences across countries.
  - When highly liquid government bonds are added to the denominator, it would result in selling of those bonds and invite unnecessary confusion. This will work against the intent of the regulations, which is to encourage holding high-quality liquid assets.
- ✧ Therefore, we view that leverage ratio should be introduced after considering more flexible implementation based upon the circumstances in specific jurisdictions. Leverage ratio should not be used as a regulation under Pillar 1. Rather, leverage ratio should be treated as a regulatory tool for Pillar 2 monitoring based on multiple metrics adapted to regulatory content.
- ✧ To maintain consistency with liquidity regulations, the definition of "leverage ratio" should exclude government bonds and cash from the denominator.

○ High-Quality Capital (Paragraph 208)

- ✧ We propose that the capital in the numerator not be limited to common equity. Capital should be flexible to cover other Tier 1 and Tier 2 capital both in times of stability and crisis. Measures to discourage risks in stable times and reduce procyclicality in times of crisis should be considered.
- ✧ A more restricted definition of capital in the numerator could undermine stability as a metric. If quality of capital improves as a result of the review, we view that there is little rationale for using a narrowly-defined capital in the leverage metric.

○ Accounting Values, Netting (Paragraphs 212-216)

- ✧ Exposure is in principle based on accounting numbers (gross assets), but there are significant differences in national accounting systems for products like derivatives and repo transactions, and there should be a uniform method for posting. This method should address the large differences in national and bank discretion as well as accounting principles in each country and IFRS.

○ High-Quality (Low Risk) Liquid Assets (Paragraph 219)

- ✧ Liquidity regulations that encourage holding of low-risk, high-liquidity assets cannot co-exist consistently unless not only cash, but especially high-quality liquid assets like government bonds, are deducted. National-level balance sheet and liquidity structures should be taken into account. There should also be indicators to limit high-risk assets.
- ✧ Financial institutions' balance sheet structures (loan-to-deposit ratio are more than 100% in Europe and the United States, and 70-75% in Japan) and business models (government bond holding ratios are only a few percent in the United States, but more than 30% in Japan) are different. Japanese financial institutions hold large volumes of government bonds that have zero risk weights. This is because Japan has a high propensity for stable savings and banks conduct appropriate risk management and stable operations based on a deep supply of retail deposits. This balance sheet structure did not trigger problems during the recent financial crisis; rather, it enhanced the stability of the Japanese financial system. In light of this background, even as a supplementary indicator, we view that using figures as-is from the balance sheet and setting absolute levels could result in this business model being rejected. From that perspective, there is a clear need to deduct at least government bonds and other low-risk high-liquidity assets.
- ✧ Including government bonds and related repo transactions in leverage ratio incorporates elements that financial institutions cannot control, which impairs the level

playing field. It may also have an adverse impact on countries' government bond management policies (including underwriting at auctions, price formation, market liquidity). These perspectives should be taken into account when studying the impact of deducting specific high-quality liquid assets.

- ✧ Considering the above together, introducing a simple leverage ratio would impair a variety of functions, such as banks' ability to fill their social infrastructure roles as deposit takers or investors in government bonds. The following adjustments should be made in designing indicators;
  - Exclude extremely high quality and highly-liquid assets (including cash, central bank deposits, and assets with zero risk weights under the Basel II framework like government bonds) from exposure when calculating leverage ratio.
  - In addition, rather than considering on-balance-sheet assets with high liquidity (risk) and low liquidity to have the same exposure on a net balance basis, a framework that incentivize lower risk assets (risk-sensitive weights like Basel II) would be better.

#### ○ Off-Balance Sheet Items (Paragraph 233)

- ✧ Credit conversion factors for unused commitments should not adversely affect stable fundraising for industries and therefore be within a scope consistent with real risk. They should also not be excessively large for transactions that do not contribute to high leverage.
  - Not all unused commitments will be real exposure, and across-the-board use of a CCF 100% credit gauge exaggerates exposure. This could potentially impair the provision of commitment lines and flexible liquidity for steady fund-raising.
- ✧ Exposure should be calculated using the CCF ratios allowed in the Basel rules for unused commitment lines. Like the Basel II rules, calculations should be weighted for risk sensitivity, not by outstanding balances.

#### ○ Disclosure (Paragraph 236)

- ✧ Disclosure should sufficiently explain why (the firm's) levels are appropriate and address measurement approaches and internal management systems.
  - Acceptable leverage levels and scopes will differ by country and even within countries due to differences in business portfolio models and risk control capacities.
  - The basis for calculating leverage ratio should be disclosed because levels will be compared whether regulations are uniform or the country has discretion.
- ✧ The assumptions and models for calculations should be disclosed, and should be monitored by regulatory authorities.

#### 4. Limiting Procyclicality

##### ○ PDs and Limiting Cyclicity (Paragraph 242)

✓ 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.

- ✧ The regulatory capital model uses a probability-based approach that is theoretically inconsistent with stress PDs. More specifically, the current risk weight function is based on a model that inputs the average value for PD to calculate a 99.9 percentile PD. Applying stress to the input PD would be a double application of stress and thus not rational. This would result in excessive capital requirements.
- ✧ Long-term average PD, rather than stress PD, should be used for estimating stable PD in order to eliminate cyclicity of the minimum capital requirement. Adding the recent financial crisis period to the PD measurement period would sufficiently resolve the problem of underestimation of PD.
- ✧ When considering this proposal, there should be a full international survey and analysis of deviations between PD estimates and actual figures. Each country should determine whether additional, supplementary long-term data is needed. At the same time, we would like to see measures to ensure that PD estimates are not excessively conservative.

##### ○ Relationship between Forward Looking Provisioning and EL (Paragraphs 243-246)

✓ 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.

- ✧ The argument for deducting the full amount of the provision stock shortfall against expected losses from common equity is to limit the incentive to amass retained earnings with a low stock of provisions. In that case, the surplus stock of provisions against expected loss should be included within common equity.
- ✧ Provisions can absorb losses by selling assets and removing them from the balance sheet, and loss absorbency of provisions on a going concern basis should be recognized for the distressed credit market. Stable provisioning against business cycles

is addressed in the document simply for loss-absorption capacity on a going concern basis. Counting excess provisioning against expected losses toward common equity would be an incentive for this.

#### ○ Sound Provisioning Practices (Paragraphs 243-246)

- ✧ Accounting standard issues have arisen from the commonly-occurring need to reverse provisions when booked excessively.
- ✧ In addition, excessive provisioning could eventually be reflected in the borrowing costs for the financial institutions' customers. This could impede borrowing and reduce the efficiency of funding markets.
- ✧ Therefore, sound provisioning levels should be rationally-set, not at excessively high levels for times of extreme stress.
- ✧ The discussions of International Accounting Standards Board (IASB) have raised concerns about practical functionality, and clearly significant costs and preparation periods will be required for application. We encourage the Committee to ensure that the framework does not go beyond the specific discussions already initiated by IASB.

#### ○ Capital Buffers (Paragraph 248)

✓ 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.

- ✧ The basis of discussion is 'equal capital for equal risk'. Capital levels that are optimal for one country are not necessarily optimal for another country due to differences in economic conditions and structures, business models of financial institutions, financial regulation and supervisory framework.
- ✧ A 'best mix' of measures is necessary to maintain stability of financial system and to keep the supply of growth capital from stagnating: striking a balance between quantitative regulations and financial monitoring and between market discipline and regulations, and separating minimum capital requirements and capital buffers.
- ✧ Thus, a global standard should be set for minimum capital requirement levels for conventional risk covered by capital. Regulatory authorities should determine capital buffer requirements in their own countries under the Pillar 2. The ICAAP framework that oversees capital adequacy in terms of risk not captured by regulatory capital should not be dismantled, and capital adequacy should be addressed by the Pillar 2, not by the Pillar 1. Systematic stability may suffer if minimum capital requirements are moved to under the Pillar 1.

- ✧ If future bank earnings are commensurate with DTA, DTA is more likely to be recovered during times of economic strength and less likely during downturns. In other words, by adjusting calculation levels, DTA can serve as a capital buffers. We believe that studying the use of restricted DTA in common equity as one of capital buffers may be valuable.
- ✧ In attempting to "reduce the discretion of banks which have depleted their capital buffers to further reduce them through generous distributions of earnings" (Paragraph 255) by limiting outflow of capital, unfair restrictions should not be imposed, for example, on the repayment of public funds.
- ✧ We believe that uniform regulations are inappropriate because of the differences among countries and banks with regard to discretionary bonus payments and dividends.

#### ○ Capital Conservation Regulations (Paragraphs 256-259)

✓ 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.

- ✧ Stable dividend is regarded as an important factor to be qualified by the stakeholders and the markets. At least, ready-made regulations are unrealistic, and financial institutions should work closely with the markets to achieve appropriate levels. We view that individual banks in each country should be responsible for handling dividend policies and other capital policies, as a joint stock company.
- ✧ Capital distributions are legal actions that constitute disposal of property rights. Since they are within the authority of the shareholders' general meeting, imposing constraints within the regulatory capital framework is inappropriate.
- ✧ The proposal to restrict profit distribution in the consultative document is effectively a hike in minimum capital adequacy. It is indeed establishment of "new minimum capital requirement" that Paragraph 257 rejects.
- ✧ Introducing restrictions on distribution will, from a practical perspective, inevitably result in the accumulation of excessive capital buffers. This is because investors in the regulatory capital instruments on which the distributions to be restricted, will expect maintenance of sufficient capital levels so that the distributions will not be restricted. Restricting dividends based on capital buffer levels will make bank share less attractive to investors and adversely impact funding.
- ✧ Restrictions on staff bonuses should be addressed through other frameworks currently under discussion. In addition, Japanese corporate law requires compensation payment to be approved at shareholders' meeting, so some constraints on excessive executive

salaries already exist.

○ Elements Subject to the Restriction on Distributions (Paragraph 259)

✧ When acquiring treasury stock through share swaps, mergers and business assignments, the following shares should be exempted: those acquired through exercising rights to purchase of shares less than one trading unit and rights of opposing shareholders to seek share purchases during a restructuring, and acquisitions of treasury shares involuntarily by the bank.

○ Solo or Consolidated Application (Paragraph 259)

✧ Restrictions on distributions are not legally or practically feasible on a consolidated basis. Under the Japanese corporate law, dividends and distributable amounts are in principle calculated on a non-consolidated basis. Fairness and the protection of minority shareholders must also be considered in cases when the bank does not hold a 100% equity stake in a subsidiary.

## International Framework for Liquidity Risk Measurement, Standards and Monitoring

### 5. Liquidity Regulations

#### ○ Liquidity Regulations (General Points)

- ✧ The consultation document was drafted to strengthen liquidity risk management in response to the financial crisis that began in the summer in 2008. We fully understand the importance and necessity and we are in agreement with its basic ideas and attitudes. We appreciate the intent on the part of national financial supervisory authorities to implement management and monitoring at a common level for internationally-active financial institutions and financial systems, and we welcome this direction.
- ✧ Nonetheless, liquidity risk profiles differ significantly in each country due to national environments, legal systems, characteristics of individual financial markets, and banks. We do not believe that funding liquidity is suited to uniform, global quantitative regulations such as those that cover capital. We would like to begin by emphasizing that the objective of setting liquidity metrics is not to build a quantitative regulatory framework that will prevent cash flow bankruptcy in all cases; rather, the significance of this exercise is to use metrics to establish rules and principles (ideals) on a global scale so that different countries and financial firms can be compared against each other and communication amongst authorities is improved.
- ✧ Despite the financial crisis in late 1990s, Japan did not strengthen management indicators, but rather, strengthened liquidity management through communication with regulators and the central bank. One reason Japanese banks were able to maintain excellent liquidity during the liquidity crisis was because the "Japan Premium" had forced Japanese banks to become less dependent on the inter-bank market and led them to the basic commercial banking operations, using deposits to develop business. Looking at the current management indicators, we agree to restrict businesses that excessively leverage the balance sheet. But as stated above, uniform regulations would adversely impact the economy as a whole. We strongly advocate to adopt management approaches that emphasize communication with regulators in light of the aforementioned success of Japanese banks.
- ✧ Based on the perspectives outlined above, we propose that the liquidity regulations drafted by the Committee serve as a framework for minimum requirements. Individual countries or regions should set the levels for supervising financial institutions respectively. Inasmuch as some countries have already begun to introduce their own liquidity regulations, it is important that the Committee take the lead and quickly

coordinate global regulations and local regulations among countries and regions in order to realize an effective framework for liquidity risk management.

#### ○ Treatment of Liquidity Coverage Ratio (LCR) (Paragraphs 20-77)

- ✓ Factors such as cash outflow and inflow are excessively conservative and should be reviewed.
- ✓ Run-off rates covering highly 'sticky' deposits should be lowered.

- ✧ In the recent financial crisis, the typical financial institution trajectories to cash flow bankruptcy were: (1) cases in which financial institutions with sizeable holdings of assets with potential liquidity risk e.g. securitized products as well as highly reliant on funding from the markets faced difficulty liquidating as market liquidity declines; and (2) cases in which financial institutions' credit deteriorated as core capital ratio declined due to losses arising from expanded credit and market risk, and cash funding became difficult.
- ✧ We understand that the ongoing review of the Basel II framework is moving in the directions to strengthen financial institution's liquidity risk management to case (1) and to strengthen credit and market risk management in order to ensure sufficient financial institution soundness to avoid cash flow bankruptcy to case (2). In the proposed LCR rules, the scope of liquidity management is defined more broadly than for case (1) and the intent is to use stress conservative scenario to capture risk. This raises the potential that excessive liquidity reserves will be required in order to provide against cash flow bankruptcy in the Pillar 1.
- ✧ The proposed LCR rules are intended to ensure sufficient liquidity for both ordinary and stress times. However, though the impacts of stress are assessed carefully, the tests do not consider the contingency plans that are implemented during stress periods. Assets can be liquidated, except for those with low liquidity, though haircut will be received. Borrowing from the central bank with eligible collateral under certain conditions and up to certain levels is also a way to raise funds, and this is consistent with financial institutions' contingency plans of up to one month.

#### ○ Fund Outflow Rates (Paragraphs 41-56)

- ✧ Stress scenarios based on LCR calculations comprise, as noted in Paragraph 22, combinations of internal and external factors, and should be considered strictly on a going concern basis. However, the cash outflow factor proposed in Paragraphs 38-70 are so strict and they appear to be the outflow rates of failed banks.
- ✧ Different countries and regions have different systems (including deposit protection

systems) and financial markets, and individual banks differ in their product offerings and credit conditions, including ratings. Deposit holders and market participants in different countries and regions behave differently. For example, deposits in Japan are highly 'sticky,' and in the past when credit issues arose, the estimated deposit outflow rate was even lower than the minimum outflow rate stipulated in the Basel. Therefore, the minimum outflow rate should be lowered, and details should be set based on each country or region's historic records and in compliance with the Basel Committee's principles.

- ✧ Internet deposits and depositing methods are all online, and daily account deposits that can be transferred over the internet should be considered stable deposits.
- ✧ The framework should address core deposits (deposits that are stable over long terms and that are not withdrawn as liquid deposits). Interest rate risk is widely and generally managed with core deposits, and we believe that this is also consistent with monitoring activity recognized under Basel II outlier standards. Specifically, we propose that liquid deposits be classified as core deposits or non-core deposits based on historical balance, and outflow rates not be applied to core deposits (outflow rate = 0%), and applied only to non-core deposits classified the same as time deposits of less than one month.
- ✧ The current definition of a small- or medium-size business in Paragraph 19 is an entity with sales of less than 50 million euros (approximately 6.5 billion yen) and deposits of less than 1 million euros (approximately 130 million yen). We believe that the definition should cover not only deposits but also liability securities (bonds). In addition, small and medium enterprises ('SME') should be treated based upon current legal definitions and banking practices in each country. For example, in Japan, the Small and Medium Enterprise Basic Law defines small and medium enterprises (determined by capital and number of employees on a sector-by-sector basis), and definitions should fit the actual circumstances of companies in a country, reflecting the realities of both government administration and financial institution management.
- ✧ Further, deposit run-off rates even for non-SME customers with strong business relationship, such as borrowers, are relatively low. Thus, we view that transaction relationships other than deposits should be an important factor for determination. Paragraph 52 outlines operational relations for unsecured funding from non-financial companies (not SMEs), but at the same time notes that '(operational relations) are not limited to these' and recognizes the discretion of each country. For example, Japanese bank and corporate relationships have distinctive practices not seen in other countries, with strong main bank-type relationships and offset rights granted to the corporate side in bank transaction agreements. Thus, in Japan, we believe that customers with liquid deposits as well as customers with loans all should be considered as having operational relationships.

✧ The treatment of inflows and outflows for credit and liquidity facilities is uneven, as providing facilities are counted as outflows but receiving facilities are not counted as inflows. Reciprocal facilities between financial institutions to ensure minor currency liquidity are needed to support corporations develop their businesses internationally. We request balanced treatment for inflow and outflows of these facilities.

#### ○ Early Termination of Time Deposits (Paragraph 43)

✧ The same outflow rates should apply to time deposits with fees for early termination that is approximately equal to the loss of interest as other deposits regardless of term. However, no outflow ratios apply to deposits with early termination fees greater than the loss of interest if the maturity date is over 30 days. Therefore, the size of withdrawal penalty would often become the standard for applying outflow rates, but when a financial institution faces a liquidity crisis, it is unlikely that the size of the cancellation fees will halt cancellations. We view that there is greater potential for this regulation to encourage a decline in customer service because deposits can be excluded from outflow rates by setting high withdrawal penalties that are disadvantageous to customers but advantageous to the institution in complying with liquidity regulations.

✧ Customers regard time deposits as different from liquid deposits and presumably behave on the assumption that they will be held to maturity. We do not think that the size of the withdrawal penalty is linked to customer cancellation behavior, nor do we think that time deposits with more than 30 days to contractual maturity should be treated differently according to the size of their withdrawal penalties.

#### ○ Treatment of Net Stable Funding Ratio (NSFR) (Paragraphs 78-91)

- ✓ 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.

✧ The NSFR is a deposit and loan regulation that states that loans must be restricted to a certain percentage of deposits if the maturity of the loan is longer than the maturity of the deposit. If NSFR is introduced as a regulatory standard requiring 100% or more, it

could impede the financial intermediary functions that are fundamental responsibilities of commercial banks.

- ✧ Specifically, the maturity structure of deposits is significantly influenced by the market environment, making it difficult for banks to proactively shift maturities into longer terms. For example, the prolonged low interest rates in Japan have resulted in very high ratios of liquid deposits. However, it is difficult for individual banks to increase their deposits even if the NSFR is required.
- ✧ The strict application of this indicator could cause banks to reduce their lending balances. Banks could face difficulty meeting demand for funds from sound enterprises and providing funding for long-term capital investments and home mortgages. This could interrupt the functions of commercial banks as financial intermediaries and would have serious adverse effects on economies.
- ✧ Further, long-term lending would have to be limited if the NSFR is introduced, and commercial banks would not be able to convert maturities (collecting deposits and making long-term loans) when brokering between depositors and borrowers. As a result, borrowers would face more difficulty borrowing funds, especially long-term funds, from banks. Borrowers would have to secure funds from the capital markets by issuing corporate bonds or by other means, but could face difficulty in procuring amounts needed quickly. In addition, small and medium-sized enterprises and individuals, which would be unable to obtain long term funds, would face difficulty with long-term financing.
- ✧ If the objective is to encourage stable structural changes in liquidity risk profiles, like LCR, NSFR should not be included under Pillar 1 as a regulatory standard requiring a level of 100% or above, but as a supervisory monitoring figure without regulatory standards. We would therefore encourage the Committee to consider moving NSFR to Pillar 2 as a framework to be administered according to circumstances in individual countries.

#### ○ Net Stable Funding Ratio (NSFR) (Paragraphs 78-91)

- ✧ The scenario assumed in calculating NSFR is, as described in Paragraph 83, stress conditions continuing for a period of 1 year, and the proposed gauge is, as it is the case with LCR, severe compared to actual circumstances in Japan. As NSFR supplements LCR by measuring long-term asset and liability structures, and it is difficult to set an appropriate stress conditions continuing for a period of one year, we therefore think, it would be sufficient for the scenario to envision ordinary conditions instead.
- ✧ Each country (region) has differences in framework (deposit insurance system and financial markets, etc.) and each bank has differences in products, credit conditions, and ratings. Depositors and market participants can therefore be assumed to behave in

different ways in different countries (regions) and towards different banks. As historical deposit balance trends reflect actual conditions in countries (regions) and banks, we hope that the proposed deposit run-off rate (higher ASF rate) as minimum standard will be lower and detail factors should be set by each country subject to the Basel Committee's principles. In addition, run-off factors of core deposits, which remain among demand deposits without withdrawal for prolonged periods, should be set at 100% when the proposed framework is deliberated.

- ✧ In NSFR, the gauge determining required stable funding (RSF) is set extremely high for loans compared to securities. This appears to stem from a regulatory intent to encourage more stable asset and liability structures for longer-term in light of the experiences of financial crisis triggered by investments in securitized instruments. When liquidity risks is emphasized, in one year, which is reasonably long term, even loan asset can be sold, placed as collateral with the central bank, or otherwise liquidated to cover shortfalls in liquidity. The RSF factor for loans should therefore be reduced.
- ✧ In addition, imposing a high RSF ratio on loans could encourage banks to scale back their core function of broadly supplying funds to industry, which would have a negative impact on the economy as a whole.

#### ○ NFSR Instability

- ✧ RSF and ASF factors for NSFR are diverged by remaining maturity at the one year point. Therefore, NSFR can be changed significantly over time even if asset and liability structure remains unchanged. For example, when a bank makes funding from the money market for a corporate lending, 100% RSF factor would apply to the lending and 100% ASF factor would apply to the funding. However, when the remaining maturity falls to less than one year, even though a 50% RSF factor is applied to a lending, 0% ASF factor is applied to a funding. In this case, even though there is no fund liquidity risk, the NSFR has worsened. Also, we view that the NFSR will be greatly influenced by interest rate conditions. For example, even if a customer's total deposits amount are stable, when the ratio of deposits of shorter than one year raises due to customer interest rate preferences, the NSFR worsens. Thus, the NSFR has an unstable metric, as it changes regardless of actual fund liquidity risk. More stable metrics would serve better for regulatory and monitoring purposes.
- ✧ As a supplementary measure to LCR, we propose, instead of NSFR, the Core Funding Ratio [(capital + all deposits + market funding with more than certain remaining term) / total amounts funded,]. This ratio is more simply calculated and would therefore be expected to be more stable. The Core Funding Ratio assumes all capital and deposits (which provide stable funds) and funds with more than a certain remaining term to

maturity (for example, one year) in market funding as core funding, and calculates the ratio within total funding. As described in Paragraph 17 and 78, Core Funding Ratio would be a supplementary metric for LCR and would meet the objective in Paragraph 78 ('Incenting structural changes in the liquidity risk profiles of institutions away from short-term funding mismatches and toward more stable, longer-term funding'). Furthermore, by definition, because this ratio is not affected by deposit term structure or changes in loan balance/term structure, the Core Funding Ratio would have less impact on commercial banks' financial intermediary functions—a matter of concern when regulations are introduced—than the NSFR.

#### ○ Scope of Consolidation (Paragraph 133)

- ✧ Paragraph 133 notes that the proposed standards "should be applied to all internationally active banks on a consolidated basis." However, even in the same financial group, the bank, which can have customer deposit and inter-bank transactions, has different funding methods from non-bank entities. We do not, therefore, believe that regulations based on the same assumptions should apply to all entities in the same group. Rather, the scope of application for these regulations should be limited to significant financial entities in the group.
- ✧ In addition, in terms of each country's regulation, the proposed standards "may be used for other banks and on any subset of entities of internationally active banks." Therefore, since the excessively conservative regulations are not introduced in different countries or regions, the Committee should clarify that it supports the introduction of individual country regulations that give sufficient consideration to the effectiveness of liquidity management structures of each banking group.
- ✧ The scope of application of liquidity regulations should in essence be determined flexibly taking into account the business models of individual banking groups. Formal application could impede creativity in group structure that responds to customers' needs, and would be akin to putting the cart before the horse.

#### ○ Transition Period

- ✧ We encourage the Committee to set sufficient transition period since preparation period for developing measurement system is necessary.

#### ○ Other Issues

- ✧ We encourage measures allowing quarterly reporting as it is the case with capital adequacy reporting, because capital regulation-related figures are used in calculating

required figures.

○ Reporting Frequency (Paragraph 132)

- ✧ The consultative document state, "the time lag in reporting should be as short as feasible and ideally should not surpass two weeks." However, it may be difficult for the reporting institution (the bank) to comply with such deadline. What constitutes "as short as feasible" should be left at the discretion of the jurisdiction and the specific period ("two weeks") should be deleted.
- ✧ In determining reporting frequency, sufficient preparatory period should be allowed so that the reporting institution (bank) does not have excessive work burdens.