September 10, 2010

Comment on the Basel Committee's Consultative Documents: *"Countercyclical capital buffer proposal"*

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the Consultative Documents: *"Countercyclical capital buffer proposal"* released on July 16, 2010 by the Basel Committee on Banking Supervision.

We hope that the following comments will be useful to the Basel Committee in finalizing the principles.

[General Comments]

We would like to express our support for the initiatives on conserving capital to build buffers at individual banks and in the banking sector that can be used in times of stress, as well as achieving the broader macroprudential goal of protecting the banking sector from periods of excessive credit growth. We would like the following points to be taken into consideration during future discussions so that these measures will function effectively and continuously as meaningful tools, without undermining the efficiency of the economy and markets.

Determining the Buffer Level

Economic cycles, market conditions and other conditions differ greatly by country, and the timing and magnitude of stress are not the same. Expectations are favorable for the role of a countercyclical capital buffer that takes into consideration these differences. On the other hand, if the capital conservation buffer meant to apply a globally uniform, certain fixed number, it could substantially heighten the minimum capital requirement and we are concerned that the financial market could judge the solvency of banks from those higher capital perspectives as well. Consequently, it may weaken the financial intermediary function of banks and lead banks to impose costs to customers, resulting in

impediment to economic efficiency.

In the first place, optimal capital level – the basis for considering the capital buffer level to be added to the minimum capital requirement – may differ by a country's financial and economic system framework (asset size of major banks against GDP, etc.), extent of a safety net (deposit insurance system, resolution regime for banks, etc.), business model (stable deposits from retail customers, complexity of banking operations or the banking structure, etc.), among others. We believe that the capital buffer level should be determined according to subsistent risks of each country and each bank in view of the aforementioned.

Two important points regarding capital buffer from the perspective of mitigating procyclicality are: 1) establishing an appropriate capital buffer level within a credit cycle, and 2) ensuring appropriate timing of build-up and release (start of build-up/release period and build-up allowance/recovery period).

A system is needed that allows banks to build up the necessary capital buffer during an economic expansion and to release the capital buffer immediately when an economic downturn occurs. In order to achieve this, the target levels of the two capital buffers – the capital conservation buffer and the countercyclical capital buffer – should be variable and left to the discretion of each country. At the same time, we call for a consistent operation - whereby both the restrictions on earnings distributions to be implemented when capital levels fall within the buffer range as well as reviews of the sufficiency of capital of each bank as required by Pillar 2 - are left to the discretion of each country. In such situations, we would also expect care to be exercised in administration by supervisors so that the financial markets do not view the capital buffer as identical to the minimum capital requirement.

Furthermore, when determining the actual capital conservation buffer level and countercyclical capital buffer level, appropriate proposals need to be made after providing clear evidence of the quantitative analysis and in view of improvements of the quality in Pillar 1 capital, changes in market practices, QIS implemented in April 2010, and other factors.

Moreover, the required capital buffer level is an issue that should be discussed according to the individual sufficiency level, after considering the improvement in the quality and quantity of the minimum capital requirement (including forward looking provisions).

Considering unfamiliarity of this proposal, sufficient time would be required to prepare for the capital buffer calculation for each bank, and the effectiveness of this proposal must also be validated. Therefore, the process must proceed cautiously, which includes determining the timing of the introduction after conducting preliminary calculations or the establishment of a testing period. We believe that allowances should also be made for the timing of implementation of buffers requirement to lag behind the implementation of revised minimum capital requirement.

Scope of Application of the Regulations

Applying the constraints of these regulations only to the banking sector may not prevent an excessive supply of credit (bubble) at the entire macroeconomic level and therefore may not become a truly efficient policy. For this to function more effectively as a policy, we believe that the Financial Stability Board (FSB) should investigate responses to core macroeconomic environments that extend beyond individual sectors and consider that applying same framework would improve the true effectiveness and fairness of this regulation.

[Specific Points]

National buffer decisions and jurisdictional reciprocity (Consultative Document: p. 3 and p. 4)

The optimal capital level that provides the basis for considering capital buffer levels as add-ons to the minimum capital requirement may differ according to each jurisdiction's financial and economic structures (assets of major banks as a percentage of GDP, etc.), its safety nets (deposit insurance, bankruptcy procedures, etc.) and its business models (availability of stable fund-raising from retail deposits, complexity of banking operations and organizations, etc.). Each jurisdiction should therefore determine the overall capital buffer level. We propose that jurisdictions be allowed guided discretions with respect to the capital conservation buffers, which constitute a capital buffer, as well as countercyclical capital buffers.

Common reference guides and principles to promote sound decision-making (Consultative Document p. 4 and p. 5)

This section discusses aggregate private sector credit/GPD and other metrics as objective guides, the potential exists for gaps between the authorities and the private sector in perceptions of the state of credit supplies and timing of implementation. Metrics should not be referred to uniformly and mechanically in making decisions regarding adding on a countercyclical capital buffer, the amount of the add-on and the timing of provisioning and release. Rather, a more general judgment is needed that considers private sector perceptions of the macroeconomic environment, and this requires steps to ensure appropriate communication with the private sector. We propose private sector's actual views be monitored and incorporated into the comprehensive judgment made by the authorities in establishing a buffer.

Consultation and evaluation (Consultative Document: p. 5 and p. 6)

We wholly agree with the Basel Committee's statement that "given the novelty of the proposal…it would be prudent for it to formally evaluate the buffer's performance in due time…[and] any evaluation would ideally take place after most Committee-member jurisdictions have gained experienced over a full credit cycle with the proposal in

place." We advocate a cautious process in the introduction of capital buffers and capital distribution constraints. For example, as with the process for implementation of the leverage ratios, there should be addressed “observation phase” (until a full credit cycle has been experienced by most member jurisdictions).

Principles underpinning the role of judgment (Consultative Document: p. 7 through p. 9)

Principle 4, promptly releasing the buffer in times of stress can help to reduce the risk of the supply of credit being constrained by regulatory capital requirements.

The proposal states, "When a decision is taken to release the buffer in a prompt fashion, it is recommended that the relevant authorities indicate how long they expect the release to last." We believe this is an extremely important point from the perspectives of capital policy and accountability to investors. We propose an explicit statement of the release period in case of more gradual releases of the buffer.

Principle 5, the buffer is an important instrument in a suite of macroprudential tools at the disposal of the authorities.

While Loan-to-Value rules and capital buffers could serve as extremely effective regulatory tools to constrain excessive credit growth in specific sectors, the effects are essentially the same as rules to control total lending amounts. In particular, when such measures are used at the same time with countercyclical capital buffers they have the potential to trigger a rapid contraction of lending that will adversely impact the economy. While authorities are free to use such regulatory tools, they also have a responsibility to suppress procyclicality; when making use of them, they will need to cautiously evaluate their impact, including an emphasis on communication with the private sector, the same as for capital buffers.

Further, announcements regarding decisions to add on capital buffers or release buffers may, depending upon the process, have an impact similar to the "announcement effect" currently used by central banks. Not only financial institutions but also corporates other than financial enterprises may conceivably also view these decisions as leading economic indicators, and it is therefore necessary to factor in these kinds of side effects. Particular care must be exercised so that the announcement of metrics does not

amplify cyclicality. Therefore, full coordination between bank supervisory authorities and central banks will be an important component in any announcement.

Calculating bank specific buffers (Consultative Document: p. 9 through p. 11)

The proposal states, "The buffer that will apply to an internationally active bank will reflect the geographic composition of the bank's portfolio of credit exposures. Internationally active banks will look at the geographic location of their private sector credit exposures and calculate their countercyclical capital buffer add-on as a weighted average of the add-ons that are being applied in jurisdictions to which they have an exposure." We think that the calculation of a weighted average taking account of the geographical composition of exposures is an appropriate methodology for calculating the capital buffer. However, we think the proposed regulation should be designed to facilitate practical compliance with respect to the scope of countries examined and the frequency of calculations, etc.

Data availability (Consultative document: p. 11)

We propose a more flexible the definition of ultimate risk basis to reflect the practical realities at banks. In practice, the decision of whether to use the location of the obligor or the location of the obligor's parent organization is made on a case-by-case basis.

In reality, even Bank for International Settlements statistics contain a mixture of the above-mentioned two definitions, determined in individual consultations with central banks. Likewise, for exposures with risk reduction effects, the decision of whether to assign the ultimate risk to the obligor to whom risk is transferred (collateral, guarantor) is made on a case-by-case basis. These assignments are based upon the national exposure management practices of individual banks, and reconfiguring these practices purely for regulatory would have a significant impact on operations and systems. We therefore like to see a more flexible definition, conditional upon mechanisms to constrain arbitrage activity and implementation of use tests, etc.

In light of the burdens on bank operations, we also propose application of a simplified calculation methodology when it is difficult to determine the domicile of the obligor. For example, current risk asset calculations do not take into account

circumstances at individual obligors because of the difficulty of individual monitoring. Subsidiaries that apply the Standardised Approach for calculating credit risk may assign a flat 100% risk weight to corporates or a flat 75% risk weight to total credit values below 100 million yen. For such cases, we propose a simplified calculation methodology that, for example, allows domiciles to be determined on a subsidiary basis.

Allocation of the buffer (Consultative Document: p. 11)

Many local subsidiaries depend upon their parent companies for their capital policies and there is a need to coordinate with the parent company when building and maintaining a buffer. Therefore, close communication with the parent company (parent bank) is advised when local regulators exercise their authority over earnings distributions vis-a-vis local subsidiaries.

The Japanese Corporation Law in principle requires calculations of dividends and distributable amounts to be made at the parent company individual level. Care also needs to be taken with respect to fairness and the protection of minority shareholders in the case of subsidiaries in which the firm does not have a 100% equity stake.

When local regulators do not exercise authority over earnings distributions of local subsidiaries, sufficiency of capital buffers are examined at an enterprise-wide consolidated level with the regulators in the parent company's home country. We understand that in such situations restrictions on earnings distributions would be imposed on the parent company (non-consolidated) if the buffer is insufficient, but we believe that restrictions are required to prevent restrictions on earnings distributions from being applied individually to specific subsidiaries in their group.

Interaction with Pillar 1 and Pillar 2 (Consultative Document: p. 12)

In terms of the relationship between the proposal and Pillar 2, there is a strong perception of qualitative overlap between examination of capital adequacy based on the results of stress tests required under Pillar 2 and capital buffers. We support the guidance that capital buffers be applied after making adjustments to Pillar 2 and that steps be taken to ensure that there is no overlap between Pillar 2 capital adequacy as determined in stress tests and regulation and supervision based on capital buffers.

We also strongly support the position that the proposal is not a Pillar 1 measure and

imposes no restrictions on operations other than constraints on earnings distributions. We further advocate measures to ensure that this guidance is widely understood by market participants and others.

Publishing the jurisdictional buffers and the bank-specific buffers (Consultative document: p. 12)

According to the proposal, jurisdictional countercyclical capital buffers are to be determined on a "quarterly or more frequent basis." We would like to see this guidance more fully take into account the practical feasibility of bank specific capital buffer calculations.

More specifically, we believe practical difficulties will arise when changes in jurisdictional countercyclical capital buffers that occur after the end of the fiscal year are noted in disclosure documents, and would therefore propose that jurisdictional countercyclical capital buffers to be applied, when calculating bank specific capital buffers, are allowed to be the most recent buffers on or prior to the date of calculation for regulatory disclosure of capital ratios and other related matters. In other words, we think that jurisdictional capital buffers published as of the base date should be applied.

Selecting the authority to administer the buffer (Consultative Document: p. 13)

The introduction of these rules will provide control over leverage at the macroeconomic level and therefore represents a change in the modality of macroeconomic policy management. We therefore believe that full discussion is needed among jurisdictional central banks and supervisory authorities regarding the relationship between controls on leverage at the macroeconomic level and existing macroeconomic and monetary policy, the feasibility of the rules and how they can be coordinated.

Annex 1

Recap of the capital conservation buffer (Consultative Document: p. 14)

We agree with the objective of capital conservation buffers to "conserve capital to build buffers at individual banks and the banking sector that can be used in stress." On the other hand, the capital buffers required to maintain and strengthen the soundness of the financial system will differ from jurisdiction to jurisdiction in reflection of the structures of financial and economic systems, the safety nets in place, the ratio of direct to indirect finance, the complexity of operations and organizations and other aspects of business models. From this perspective, it is desirable that jurisdictions have some discretion in determining appropriate levels of capital buffers and the timing with which they are applied.

If the capital conservation buffers presented in the draft for consultation are to be fixed and applied across the board, they will understate jurisdictional variances and potentially distort the credit supply capacities of banks. In addition, sound banks will always maintain capital in excess of the fixed buffer because fixed buffers and the restrictions on earnings distributions when the buffer is insufficient represent significant restrictions on shareholders' fundamental right to receive dividends and the mechanisms for determining those dividends. As previously discussed, this constitutes essentially a hike in minimum capital requirements and financial markets may use this to gauge solvency for banks.

Nonetheless, variable buffers like the countercyclical capital buffer are desirable because they focus on aggregate private sector credit/GDP and can be established at levels that are appropriate to circumstances in the jurisdiction taking account of other metrics. We would therefore expect schemes for capital conservation buffers that also are flexible and maintain the discretionary authority of jurisdictions. Once appropriate, feasible administrative rules are established, variable buffers are more rational from the perspective of capital efficiency and will help to constrain procyclicality by requiring an active buildup of capital during times of economic expansion and allowing release during times of stress.

Even with flexible capital buffers, however, banks will face difficulty projecting capital levels to be targeted in the absence of a ceiling. We therefore believe that ceiling

values should be established prior to the introduction and application of these new rules.

If regulatory authorities decide to release capital buffers during times of stress, they should also indicate how long that period will extend. Indication of the period of ongoing release will increase the latitude of banks' capital management and enable banks to practice more forward-looking capital management.

The imposition of rebuilding conditions at the time of capital buffer release will serve as a negative incentive on release. Capital buffers are likely to fail to function as buffers and be in effect hikes in minimum capital requirements. If, for example, there are restrictions on dividends until buffers are rebuilt, banks' shareholders will have an a priori opposition to the release of buffers. Similarly, there are false incentives at work if risk assets are reduced in order to maintain dividends. At the very least, the proposal should take account of the potential for negative impacts during times of stress when institutions are unable to expect profitability.

We would like an explicit statement that, particularly during times of stress, capital conservation buffers can be released without the imposition of capital distribution constraints.

We must also note the potential for negative incentives if, for example, ratings agencies were to downgrade credit ratings when buffers are released but not upgrade credit ratings as buffers are built.

We agree with the concept of earnings distribution constraints being invoked to promote retained earnings when capital falls into the buffer range. However, from a practical standpoint we believe that they should be within the range of distributable earnings because under the Japanese Corporation Law dividends are in principle determined by resolutions of the General Meeting of Shareholders (the law stipulates that shareholders initiate this agenda item, which must be either a shareholder proposal or a revision of a board proposal). This represents a significant restriction on shareholders' fundamental right to receive dividends (Article 105:2 of the Japanese Corporation Law) and the mechanisms with which they are decided, and the proposal should therefore take full account of the legal problems raised with respect to shareholder rights.

Restrictions on executive bonuses should be dealt with in other frameworks currently under discussion. In addition, corporate law requires General Meetings of

Shareholders to approve executive pay, etc, so there are already some constraints on the payment of excessive executive salaries.

Treasury stock is acquired in conjunction with share exchanges, mergers and business assignments, and within this are some elements that do not intend to return profits to shareholders and are not subject to the will of the bank, for instance the right to seek purchase of fractions of minimal trading units and the right of opposing shareholders to seek purchase of shares during reorganizations. These elements should be excluded.

Calibration (Consultative Document: p. 16)

The draft for consultation presents a framework to restrict earnings distribution according to the ratio of the capital conservation range (capital conservation buffer plus countercyclical capital buffer) to the amount by which a bank’s capital exceeds the minimum requirement.

We understand the desire to maintain high levels of capital to prevent financial crisis. However, we also think an explicit statement is needed regarding the differences in the management of minimum capital requirements and capital buffers so that the establishment of capital conservation buffers does not constitute what is in effect a hike in minimum capital requirements. Excessive emphasis on capital adequacy might result in a neglect of capital efficiency that significantly impairs investment incentives for the banking sector. Therefore we believe there needs to be further study given to the balance between these two requirements, minimum capital requirements and capital buffers.

We also caution against excessive reliance on stronger capital surcharges as a means of stabilizing the financial system and preventing the recurrence of financial crisis; it is important to appropriately capture risk and to combine this with the necessary regulation and supervision.

There is a concern that excessive demands for capital increase could, paradoxically, induce market participants to amplify cyclicality. In other words, they could serve as incentives for excessively cyclical behavior that may exacerbate cyclicality, a point that we think needs to be fully taken into account.

Capital buffer levels comprise two elements: capital conservation buffers and

countercyclical capital buffers. There is a mutually interactive framework among capital buffer level decisions, the restrictions on earnings distribution invoked when capital levels fall into the capital buffer range and the verifications of capital adequacy required of individual banks under Pillar 2. In light of this, we believe it is preferable for these to be administered in an integrated fashion at the discretion of jurisdictional authorities.

Annex 2

The credit-to-GDP guide (Consultative Document: p. 17 through p. 19)

Section 1 of Annex 2 discusses the superiority of credit-to-GDP over other indicator variables as a reason for its selection. However, it also says, "the evidence presented in this annex suggests that while historically the credit/GDP gap would often have been a useful guide in taking buffer decisions, it does not always work well in all jurisdictions at all times." We think that mechanisms must be fully cognizant of the fact that GDP is generally a lagging indicator of economic performance and need to give jurisdictions flexibility in decision-making on countercyclical capital buffers so that they can adequately take into account other indicator variables as presented in the draft for consultation. We also think there should be regular verifications of the meaningfulness of the credit-to-GDP gap after rules are introduced because doing so will increase its meaningfulness as an indicator.