

February 4, 2011

Comments on the Basel Committee on Banking Supervision Consultative Document, *Capitalisation of bank exposures to central counterparties*

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the Consultative Document, *Capitalisation of bank exposures to central counterparties*, released December 20, 2010, by the Basel Committee on Banking Supervision.

We hope that our comments below will assist the Basel Committee in its efforts to finalize rules going forward.

[General Points]

We would like to express our appreciation for the Basel Committee's initiatives intended to create incentives for banks to increase the use of central counterparties (CCP) while ensuring adequate capital requirement to the risk arising from banks' exposures to CCPs.

At the same time, for such proposals to function as meaningful tools without undermining the efficiency of trades while maintaining consistency with risk management practices of banks, we sincerely hope that the following will be taken into account.

[Specific Points]

1. Capitalisation of Trade Exposures to Qualifying CCPs (Paragraph 9 (c) of the Text and Paragraphs 114 and 119 of Annex A)

We understand that the treatment of a 2% risk weight takes into consideration the low risk of trade exposures via CCPs and encourages use of CCPs.

However, unlike mutual collateral posting agreements on derivatives transactions [credit support annexes (CSA), developed by the International Swaps and Derivatives Association, or ISDA], a unilateral (variable) margin would be required by the CCP. This would also result in inefficient fund management through opportunity costs lost and banks would incur funding

costs. Therefore, this treatment may not provide sufficient incentive for increasing the use of CCPs.

Thus, rather than a uniform 2% risk weight, lower risk weights should be allowed, in consideration of the additional factors of the adequacy of the CCP's financial resources against losses and the probability of default by each member.

Specifically, we propose a simple mechanism that considers the probability of default of the clearing member holding the largest negative position (or the probability of simultaneous default by the three clearing members holding negative positions with the lowest ratings) as a scaling factor (scalar), in order to reflect the probability of a loss event occurring in the CCP default fund.

2. Coordinating views on Calculation of Capital Requirement for Qualifying Default Fund Exposures with other stakeholders (Paragraph 9 (g) of the Text and Paragraph 117 of Annex A)

When calculating the risk-weighted assets for a qualifying default fund, the following are determined in accordance with industry and regulatory practices: risk weight, organization making the calculations, implementation schedule, results of calculation are communicated.

In this process, we understand that procedures are coordinated with other stakeholders. We therefore request that sufficient coordination is ensured, taking into account banking practices and the capital adequacy ratio calculation method.

3. Capitalisation of Qualifying Default Fund Exposures (Paragraph 9 (g) of the Text and Paragraph 117 of Annex A)

(1) Calculation of Capitalisation of Qualifying Default Fund Exposures

In the proposal, the exposure of a qualifying default fund is based on a risk weight of 20% in the Standardised Approach for credit risk, and a further reduction from the 20% by using credit risk mitigation techniques is allowed. With regard to the basis for this mechanism and related factors (C1:1.6%, C2:100%, μ :1.2), we propose that the risk weight be reduced to a level that more appropriately reflects the probability of default by each clearing member, and further takes into consideration the following points;

(i) Kccp Risk Weight

In the proposal, the risk weight of a default fund would be determined based on a 20% risk weight (given a capital of 1.6%) applied to financial institutions as clearing members. However, we request that capital requirement should not be calculated so simply and conservatively in order to enhance risk management within banks. We also note that the risk weight of a clearing member such as a bank (financial institution) is often lower than 20% and that the purpose of the use of CCPs is intended to reduce counterparty risk.

Specifically, a bank that has adopted the Internal Ratings-Based (IRB) approach should be allowed a risk weight lower than 20% if the bank can identify the contributors (financial institutions as clearing members) of a qualifying default fund and assess the default risk of contributors using the IRB approach.

(ii) “C1” factor

Similarly to (i) above, banks that have adopted the IRB approach should be allowed to apply a risk weight (capital requirement) lower than 1.6% (20% risk weight) if the bank can identify the contributors (financial institutions as clearing members) of a qualifying default fund and assess the default risk of contributors using the IRB approach.

(iii) “C2” factor

Unlike contributions for corporates (or financial institutions), (a) the probability of a loss event occurring at a default fund is dependent on the probability of default of the financial institution clearing members, and (b) the waterfall structure and priority of loss allocation for a default fund differs from the loss allocation approach for corporates' equity. Thus, a 100% risk weight, equivalent to a deduction from capital, is extreme.

Therefore, the mechanism should be such that risk weights can be lowered further by considering the probability of default of each clearing member as an additional factor.

Specifically, we propose the simple approach of addressing the probability of a loss event occurring at the CCP default fund. This would mean considering the probability of default of the clearing member holding the largest position (or the probability of simultaneous default by the three clearing members with the lowest ratings) as a factor (scalar) when calculating the capital requirements mentioned in step “iii” (in the event that the clearing organization's hypothetical required capital is lower than the reserves or retained earnings of the CCP itself).

(iv) “ μ ” factor

The most important consideration regarding the difference between being prefunded or unfunded is a financial institution’s (a clearing member) risk of incurring losses when another clearing member defaults through participation in a CCP scheme. Depending on the terms of the contract with the CCP, a scalar of 1.2 may be excessive. Therefore, we believe that these scalars should not be set uniformly, but rather carefully and individually. Specifically, flexible responses should be allowed. For example, a level equal to prefunded default fund contributions ($\mu=1.0$) could be applied depending on the terms of contract. Alternatively, the probability of default of a clearing member holding the largest position (or the probability of simultaneous default by the three clearing member companies with the lowest ratings) could be added to the prefunded level ($\mu=1.0$).

(2) Use of Fixed Risk Weights

Banks will be required to hold a certain amount of capital depending on the default fund to which they have contributed. However, the formula is excessively complex. We are concerned that this may discourage banks from participating in a qualifying CCP.

We propose, for example, it would also be allowed that capital requirement be calculated depending on retained earnings, etc., and classifying the capital requirement by one of a few categories.

4. Determination of Qualifying CCPs (Paragraph 106 of Annex A)

In calculating capital requirements, risk weights are largely influenced by a bank’s designation as a qualifying CCP. This has a great impact on risk-weighted assets. We therefore ask the Basel Committee to clarify the body responsible for determining qualifying CCPs, the frequency of determinations, and whether individual qualifying CCPs are publicly noted as such.

5. Risk Weight to a Default Fund for Non-Qualifying CCPs (Paragraph 120 of Annex A)

This proposal calls for a risk weight of 1,250% (equivalent to a deduction from capital) to be applied to a default fund for non-qualifying CCPs. However, the 1,250% risk weight (equivalent to deduction from capital) would be too high compared to the Standardised Approach of Basel II, which sets the risk weight of exposures for depository financial institutions at 20%. In

consideration of this imbalance, the risk weight applied to a default fund for non-qualifying CCPs should be lowered to approximately the same level as the risk weight to exposures for corporates.