

September 27, 2013

Comments on the Basel Committee on Banking Supervision's Consultative Document: The non-internal model method for capitalising counterparty credit risk exposures

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the consultative document: *The non-internal model method for capitalising counterparty credit risk exposures*, released on June 28, 2013 by the Basel Committee on Banking Supervision (the "BCBS").

We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalising the rules.

General Comment

○ **Optional use of the Current Exposure Method (CEM)**

The BCBS should continue to allow the option to use the CEM even after the implementation of the non-internal model method (NIMM). The NIMM uses a more complicated formula as compared to the CEM, and is not necessarily a suitable framework for those organisations such as small-sized banks or non-financial business entities within a banking group which have relatively smaller interbank trading activities in derivatives and thus have limited risk mitigation effect through netting. For those organisations, additional benefits in risk management obtained by the application of the NIMM are limited and do not outweigh the additional burden that may be incurred in systems development or calculation. The BCBS should therefore permit the optional use of the CEM which is an easier approach in terms of calculation and implementation.

It should be noted that we recognise that, if the optional use of the CEM is permitted, the add-ons calculated under the CEM need to be re-calibrated to the appropriate level in light of the result of quantitative impact studies.

It is understood that the optional use of the CEM is not necessarily consistent with the goals pursued in the initiative to balance risk sensitivity, simplicity and comparability discussed by the BCBS. Nevertheless, while we agree that implementing the NIMM for all areas assuming interbank transactions and transactions with large-account customers improves the

comparability of the exposure at default (EAD), we respectfully emphasise that there are some cases where continuous use of the CEM is more reasonable from cost-benefit perspectives taking into account differences in business models among banks and in properties of transactions they engage in.

○ **Consideration of the impact on transactions with non-financial business entities**

The BCBS should give due regard to the impact of introducing NIMM in the context of bilateral derivatives with non-financial business entities as well as those related to project finance which supports long-term infrastructure investments.

The NIMM is a framework to calculate exposures to non-financial counterparties without netting or margin agreements more conservatively as compared to the CEM¹ (please see the supplementary comment for specific examples), and thus, if implemented, transactions with these counterparties will inevitably be subject to additional capital charge which is not required in the current regime. It is our concern that this may particularly affect commercial banks when they make such transactions taking into account such additional charges.

The NIMM also has an impact on derivatives entered into for project finance supporting long-term infrastructure investments for the purposes of development of emerging countries. Specifically, it increases the capital cost for interest rate swaps which is used to fix cash flows. Such an increase in capital cost may adversely affect the overall profitability of the financial institution (the provider of funds) and eventually would undermine the “availability of long-term investment finance for economic growth”² which is an area of concern for the G20 and FSB.

It should also be noted that, in addition to counterparty credit risk charges, there is a significant capital impact on banks using the standardised risk measurement method to calculate the CVA capital charges.

In view of the above, the implications on these transactions should be duly considered and measures should be taken to minimise the negative impact by, for example, re-calibrating each parameter of the NIMM. Even if such measures are not allowed, the BCBS should at least take measures to mitigate the impact of radical changes such as providing banks with a sufficient preparation period or allowing an optional application of the CEM to the existing transactions.

¹ For example, in comparison with the CEM, the level of add-ons of plain vanilla interest rate swaps and their capitalisation approximately doubles and increases by 7 times in the case of the maturity of 1.5 years and the maturity of 5 years, respectively.

² FSB (Feb 2013): Financial regulatory factors affecting the availability of long-term investment finance
FSB (Aug 2013): Update on financial regulatory factors affecting the supply of long-term investment finance

○ **Overall calibration**

The BCBS should make sure that the NIMM is not an excessively conservative framework through a quantitative impact study, and make a final calibration to each parameter from holistic perspectives.

The NIMM takes conservative approaches in many aspects of the calculation such as recognition of negative MTM/excess collateral and hedging benefits, level of alpha and add-on factors, and adjustments to the margin period of risk. The BCBS therefore needs to review the framework so that the resultant EAD, which is calculated in such a way as obtaining the least common multiple, is not unnecessarily conservative, not exceeding the acceptable level.

Specific Comments

○ **Treatment of the maturity of interest rate derivatives**

- (1) The consultative document's proposed approach to simply multiply the notional amount by the remaining maturity to calculate the effective notional amount for interest rate swaps is considered to be too conservative. The NIMM does not take into account the effect of time value across remaining maturity, and thus produces an effective notional amount which lacks necessary risk sensitivity. The BCBS, therefore, should make adjustments such as applying maturity specific haircuts to reflect the concept of duration so that the sensitivity of the remaining maturity to the adjusted notional gradually reduces as the maturity lengthens.
- (2) As described in paragraph 47, the consultative document sets a floor of one year to the remaining maturity by which the notional amount is multiplied to produce adjusted notional. However, there is no theoretical reasonableness for applying such a floor, and it should rather be removed to reflect the sensitivity of those transactions with maturities of less than one year.

○ **Offsetting foreign exchange derivatives positions**

Based on the consultative document's proposal which only allows offsetting of long and short positions in the same currency pair, no offset would be recognised for the transactions (i) to (iii) shown in the following table [Assumed Transactions], although the actual positions of the three currencies should be offset by currency. This treatment is considered as overly conservative taking into account the actual amount of risks and therefore the BCBS should allow the offsetting approaches proposed in the section [Proposed Offsetting] below.

[Assumed Transactions]

(local currency-denominated)

Transaction	Currency	Long+/Short-	Amount
①	USD/JPY	+	70
②	EUR/JPY	-	100
③	EUR/USD	+	60

[Proposed Offsetting]

(i)dividing each transaction

(local currency-denominated)

Transaction	Currency	Long+/Short-	δ	Amount
①-1	USD	+	1	70
①-2	JPY	-	1	70
②-1	EUR	-	1	100
②-2	JPY	+	1	100
③-1	EUR	+	1	60
③-2	USD	-	1	60

(ii)netting by currency

Currency	Long+/Short-	Amount
USD	+	10
JPY	+	30
EUR	-	40

(iii)determining the effective notional with the absolute figure of buying and selling balances

Long+/Short-	Amount
+	40
-	40

$$\begin{aligned}
 \text{Effective Notional}^{(FX)} &= |Amount_{long}| \\
 &= |Amount_{short}| = 40
 \end{aligned}$$

○ **Responses to Questions**

Q1. Should the Basel Committee replace the CEM and SM with the NIMM in all areas of the capital framework? What are the benefits and drawbacks of using the NIMM in each of these areas?

We support that the NIMM should be applicable in all areas of the Basel framework including the margin requirements for non-centrally-cleared OTC derivatives on the basis that it enhances comparability and prevents undue burden for measurement by making several methods available.

However, as described in the General Comment, the CEM should not be completely removed at least in the capital framework but rather should be retained as one of the options even after implementation of NIMM.

Q4. Does the above approach reflect the replacement cost of margined transactions? Are there any other collateral mechanics that the Base Committee should consider?

The BCBS should explicitly allow entities to calculate the replacement cost for margined transactions by using the formula “ $RC = \max[V - C; 0]$ ” instead of the formula set forth in paragraph 30 if there is no outstanding derivative transaction subject to a margin agreement. The consultative document is based on the concept that the aggregated amount of TH+MTA represents the largest credit exposure to counterparty. Unlike commitment line agreements where the customer has the right to draw down on such lines, individual derivative transactions will not be executed unless agreed by the parties to the agreement. Therefore, if no actual derivative transaction exists, the “TH+MTA” should not be deemed as the largest credit exposure extended to the counterparty.

Q5. Of the options under consideration for recognising offset across hedging sets, which treatment is preferred? What number of maturity buckets is appropriate to consider?

With regard to the options of partial offsetting for interest rate derivatives, we support Approach 1, rather than Approach 2, on the basis that its outcome better represents the actual residual risks taking correlations among maturity buckets into account.

Supplementary Comment

- Example of a calculation for add-ons of a derivative transaction with a typical corporate client

(\$ thou)

Assumptions		Add-on	
Counterparty / Transactions Info		Derivative (CEM)	Derivative (NIMM)
Asset Class	Corporate	EAD	5
Hedged Transaction / Hedging Transaction	Loan Balance \$1,000 thou (10yr-SL amortization) IR swap (full matched)		35
Derivatives Info			7 x(EAD)
MTM			
Collateral			
Maturity			
Add-on rate	0.50%		

