September 27, 2013

Comments on the Basel Committee on Banking Supervision's Consultative Document:
Capital treatment 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: *Capital treatment of bank exposures to central counterparties*, 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 framework.

General Comment

We respectfully express our support for the BCBS's initiative intended to finalise the interim framework to create a more appropriate incentive for banks to use central clearing counterparties (CCPs), and at the same time expect our following comments will be considered in facilitating more meaningful implementation of the final framework.

- To ensure that prudentially supervised CCPs are determined by every clearing member and its client as qualifying CCPs (QCCPs) evenly and without any practical obstacles, the criteria for determining QCCP status set out in the interim rules should be reviewed from the perspective of whether such rules have addressed practical issues identified in jurisdictions where the Basel III has already been implemented. (See Specific Comment 1)

- To improve the incentive for banks to centrally clear their transactions via prudentially supervised CCPs, the baseline 1,250% risk-weight applied to default fund (DF) exposures should be re-calibrated to generate a lower risk-weight for such CCPs.   (See Specific Comment 3)

- It is considered more appropriate to derive the reference level of DF resources (RLDF) directly from K(NIMM) without any reference to DF^{Cover*} ("RLDF = K(NIMM)"), which would be justified by the following reasons. Firstly the complexity of the framework is

compounded by incorporating DF^{Cover*}. Secondly DF^{Cover*} is a scenario-based measure that does not correspond to other statistics-based risk measures specified under the Basel capital adequacy framework, which would eventually undermine the comparability of risk-weights among CCPs due to the possibly incomparable scenarios chosen by CCPs. (See Specific Comment 4)

Specific Comments

1. **Review of the QCCP determination criteria and development of information disclosure framework**

The BCBS should evaluate whether the overall framework for capital treatment of bank exposure to CCPs, including the suggested changes in this consultative document ("CD") as well as the interim rules, is truly effective. Our comment first states the current situation, and then discusses our two proposals on issues that are considered to be the most crucial.

● Current situation

The interim rules set out the following two criteria for determining the QCCP status: (1) the CCP is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the CCP on an ongoing basis, domestic rules and regulations that are consistent with the CPSS-IOSCO Principles for Financial Market Infrastructures (PFMIs); and (2) the CCP must calculate numbers necessary for a bank to calculate risk-weight and make such numbers available to the bank.

In Japan, Basel III has already been implemented. However, in determining whether these criteria are met, an extremely inefficient practice is imposed on banks because each bank needs to access every CCP (i.e. there are N x N number of communications) in the situation where the banks and the CCPs have not sufficiently identified each other's responsible departments and personnel. This could result in situations where a bank that has obtained the prescribed data from a CCP determines the CCP to be a QCCP, while another bank which has failed to obtain such data treats the same CCP as a Non-QCCP. In addition, in cases where a bank indirectly participates in a CCP as a client, rather than as a direct participant, it becomes much more difficult in practice to determine whether the above criteria are met.

Case (i) "Where a bank is a direct clearing member of an overseas CCP *A* for repo transactions"
The means used and divisions responsible for providing the Kcmi number (for the criterion (2)) are not available from the website of the CCP *A*. The bank identified and

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contacted two persons; one was in charge of regulatory affairs and the other was from a department responsible for the compliance with PFMIs. However, neither of them has responded to the bank's inquiries.

Case (ii) "Where a bank invests in a fund *B* which makes investment through a broker *C* which settles derivative transactions using an overseas CCP *D* (the bank applies the "look-through" approach")

The bank has requested the fund *B* to confirm whether the broker *C* can obtain Kcmi number of the CCP *D*. However, the contact person of the fund *B* and the broker *C* had no understanding of the banking regulation or the Kcmi, and could not provide the information about the CCP *D*.

● Proposal (i): Review of the QCCP determination criteria

The availability of information, or whether the numbers required in the criterion (2) is available, has nothing to do with the "prudential level" of CCPs, and hence is fundamentally different from the criterion (1). This criterion of availability also entails an issue of lack of comparability; specifically, "a certain CCP is not uniformly determined as a QCCP by all clearing members." It is therefore not considered to be appropriate to establish such criterion considering the goal being currently sought by the BCBS[§].

The following two options may be taken to address the above issues:

The first option is to exclude the criterion (2) from the QCCP determination criteria and require only criterion (1) which indicates the "prudential level" to be met. Even if the criterion (2) is eliminated, the calculation of DF^{Cover*} which is necessary to ensure soundness of CCPs remains performed on an on-going basis provided that PFMIs are satisfied. In addition, to address situations where required numbers are not available, it is considered necessary to define the approach for calculating the risk-weight of a DF (similar to Method 2 set forth in the interim rules.)

If the first option is not feasible, an alternative option is to replace the criterion (2) with the requirement for CCPs to disclose required numbers (Kcm[**], RW_TE) using a common format across CCPs. This option will allow CCPs to provide their information equally to all

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[**] In this context, Kcm is denoted as follow using the terms of the Consultative Document:

$$Kcm = \frac{K_{CMi}}{DF_i^{\Pr ef}}$$

clearing members, and eventually it is expected that the determination of QCCP status will be carried out properly (i.e. determined as a QCCP) in conformity with the level of soundness of CCPs by any and all banks, including those engaged in small amount of transactions or indirectly involved in central clearing. QCCPs will also benefit from being relieved from burdensome administrative tasks and inquiries from a number of individual banks.

● Proposal (ii): Development of an information disclosure framework by the BCBS

As discussed above, the determination of whether the criterion (1) is met is critical to assessing the soundness of a CCP. However, whether such determination can be made is also a matter of practical feasibility, which depends on investigation efforts by financial institutions or the level of information disclosed by CCPs and supervisors.

With a view to avoiding any situation where a well-deserved QCCP is determined as a Non-QCCP due to a lack of practical feasibility which is an issue similar to the one raised in Proposal (i), the BCBS should develop an information disclosure framework, through for example publishing a list of QCCPs meeting the criterion (1), or encouraging national authorities to disclose information relating to the criterion (1).

2. **Transitional arrangements for the QCCP determination**
   Until the above mentioned review of QCCP determination criteria and improvement to the information disclosure framework are completed, and the determination of QCCP status can be made steadily and without any practical obstacles, the BCBS should consider extending the expiration of the "Transitional arrangements for the QCCP determination" specified under Basel III frequently asked questions for a reasonable period.

3. **Creating incentive for promoting central clearing**
   The baseline risk-weight of 1,250% proposed in the CD in calculating the capital charge on DF should be re-calibrated from the following standpoints of creating incentives for promoting central clearing:

   （1）　*Comparison with bilateral transactions (See Supplemental Discussion 1)*
   Comprehensively taking into account capital charge on members' DF contributions, funding cost associated with collateral and DF, and the practical burden incurred in respect of determining QCCP status, banks do not always benefit from central clearing using QCCPs. As indicated from Assumption (i) provided in the Supplemental Discussion 1, unless derivative transactions with certain exposure

amount are transferred to CCPs, no benefits are realized from a cost-benefit perspective relative to bilateral transactions. If the final framework seeks a situation where the majority of clearing members enjoy benefits to centrally clear their transactions, the BCBS should consider reducing the level of capital charge on DF to bring absolute benefits to banks.

Additionally, as shown in the Assumption (ii) provided in the Supplemental Discussion 1, banks do not have an incentive for contributing to DF top-ups. Rather, banks will experience an increase in the minimum trading volume, which is their break-even point.

On this basis, the BCBS should review DF top-ups incentive within the Kcmi and the RW_{TE} formulae through a comparison analysis with bilateral transactions.

（2）*Comparison with Non-QCCPs*
Even in the case that DF^{Pref} equals to RLDF, the CD requires the level of capital charge on DF for QCCPs with a risk-weight of 1,250%, which is the same level as applied to Non-QCCPs specified in the interim rules. This is not considered sufficient to create an incentive for banks to contribute top-ups of DF.

4. **Appropriateness of *Cover****
The BCBS should reconsider the introduction of Cover* requirement for the RLDF calculation from the following perspectives:

（1）*Increase in complexity of the framework due to introducing Cover**
Paragraph 24 states that the BCBS proposes to introduce a floor for K(NIMM) in order to restrict QCCPs from intentionally reducing the value of DF^{Cover*}.

In the situation of DF^{Cover*}>K(NIMM), if, as is indicated in the CD, the BCBS implicitly permits CCPs to calibrate DF^{Cover*} down to the level of K(NIMM) through reviewing stress scenarios developed by CCPs, such a treatment means that the BCBS allows banks to always derive the following outcome: RLDF=K(NIMM). In this situation, the introduction of a new concept *Cover** has just added unnecessary complexity to the final framework.

Sample Cases for QCCP

DFcover*	Kccp(NIMM)	Proposed RLDF		Assumption: CCP adjusts DFcover* through the revision of its stress senario.	Proposed RLDF (implied)	
10	15	15	Kccp(NIMM)		15	Kccp(NIMM)
10	5	10	DFcover*		5	Kccp(NIMM)

（2） *Inconsistency in the definition of the risk measure / Lack in comparability of Cover**

The calculation of regulatory capital charge for DF and trade exposure (TE) should be based on the same risk definition and concept of exposure and default consistent with other on-going capital adequacy frameworks. Therefore, the introduction of Cover* requirement which contradicts with the concept underling the Basel framework is not considered to be appropriate.

Specifically, DF^{Cover*} is calculated on the basis of stress scenarios developed by individual QCCPs, and accordingly, the basis of calculation is not comparable across QCCPs. Additionally, there exist other issues, such that banks may not be able to verify the appropriateness of DF^{Cover*} values, as well as banks may be forced to change their capital requirements due to unpredictable and uncontrollable events such as "a change in a stress scenario by a QCCP" which is not dependent on the changes in trading volume or counterparties of QCCPs.

In this regard, our view is that it is more appropriate to define RLDF as "RLDF = K(NIMM)." Incentivising CCPs to hold "sufficient DF" as QCCPs is already addressed by the supervisory framework under PFMIs. Consequently, we are of the opinion that it is not considered to be necessary to introduce the *Cover** concept into the Basel capital adequacy framework in order to give an incentive for CCPs to raise DF.

If the introduction of the *Cover** concept is unavoidable, DF^{Cover*} should be used only after the calibration based on the Probability of Default (PD) and other factors is made to ensure that there is no significant difference between K(NIMM) and DF^{Cover*}.

5. Responses to questions

Q1. Which of these two proposed methodological approaches best satisfies the objectives which the capital treatment seeks to achieve and why?

We support the ratio approach since the tranches approach has the following issues:

（1） Under the tranches approach, the risk-weight stays constant at 1,250% for a capital charge on any shortfall of DF, until it reaches RLDF. Therefore, this approach, will not create an incentive for clearing members to contribute DF for its structural reason. On the other hand, under the same condition, the ratio approach will lower risk-weight.

（2） The tranches approach may impose an excessively high capital charge when the amount of contribution to DF is small (See Supplemental Discussion 2.) Consequently, the function under this approach is considered to be unstable.

（3） In the case of $DF_{CCP} < RLDF \leqq DF^{Pref}$ as provided in the formula (ii) in para. 37,

if an individual clearing member makes an additional DF contribution, then adversely, the risk-weight will increase. In this regard, the function under this approach is also considered to be unstable.

Nevertheless, as noted in Specific Comment 3, the current proposed level of risk-weight (1,250%) for DF should also be reviewed even if BCBS chooses tranches approach.

Q4: The Committee invites comments on this potential risk sensitive approach to capitalising trade exposures to CCPs.

The maximum risk-weight of 20% is not considered to provide a sufficient incentive for central clearing, and hence a lower RW should be set.

The PD of financial institutions with a sound financial position would likely be assigned 0.03% which is the floor of PD. In such a case, the risk-weight calculated under the internal ratings-based approach will be approximately 8%.

If bilateral derivatives are transferred to CCPs, TE should at least be lower than the risk-weight of 8% because (i) transferred transactions would be treated more prudentially than bilateral derivatives, and (ii) additional capital charge will be imposed on DF that banks must contribute.

Further, since the proposed risk-weight of TE to CCPs incorporates the risk sensitivity, banks need to obtain data (RW_TE) from CCPs in addition to Kcmi specified in the interim rules. As discussed in Specific Comment 1, to ensure feasibility for banks to obtain such data, it is requested that the BCBS discuss how such additional information will be obtained and disclosed.

1. **Cost comparison/Break-even point**

($ mil)

Assumption	(i)	(ii)
RW of counterparty ＊	13.98%	same
RLDF	3,000	same
DF ccp	20	same
DF cm pref	3,000	3,020
Number of CM	100	same
DF i	30	50
Maturity of derivatives	3	same
S.F. for IRS	0.5%	same

＊PD=0.07% (worth of S&P:A), LGD=45.0%, same maturity as above
assumptions: IRS, WACC=6%, funding cost rate=1%
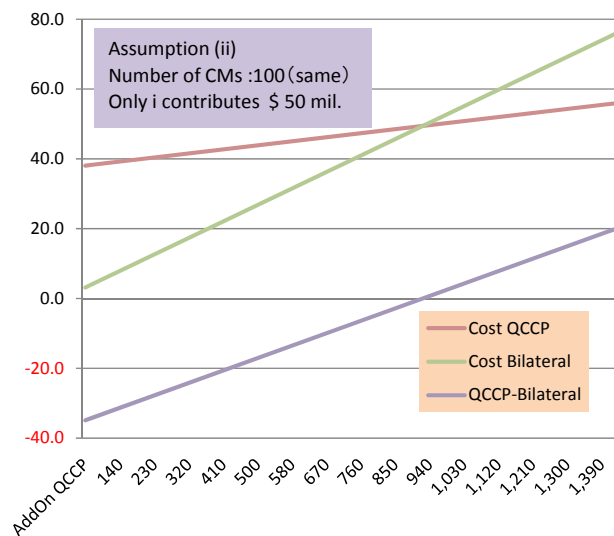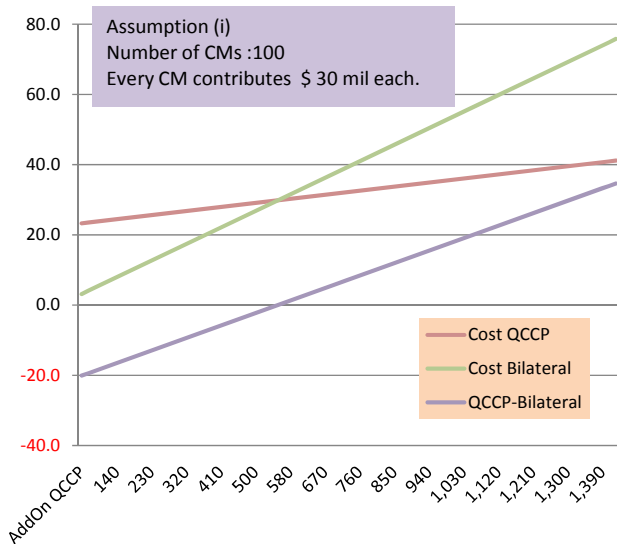
Vertical line: Capital cost + Funding cost

> For simplicity, Kcmi for the capital cost is defined as max (the K of the ratio approach, the K of the tranches approach).

> Additionally, CVA capital charge is not added on to the capital cost of bilateral transactions.

Horizontal line: Add-on to derivatives transferred to QCCP (the unit is in USD million.)

● As discussed in Assumption (i), banks will benefit from transferring their derivate positions to QCCP only when the amount of capital add-on imposed on centrally cleared transactions exceeds approximately USD 560 million calculated under NIMM(CCP) (notional amount of approximately USD 91 billion.)

- As specified in Assumption (ii), banks will not benefit from the reduction in RW_TE and Kcmi (i.e. the red line's slope will not sufficiently lower down) by the additional contribution to DF (+ USD 20 million.) Rather, add-on at the break-even point will rise to approximately USD 920 million (notional amount of approximately USD 154 billion.)

2. Example of where the tranches approach is not stable

(1) Tranches approach
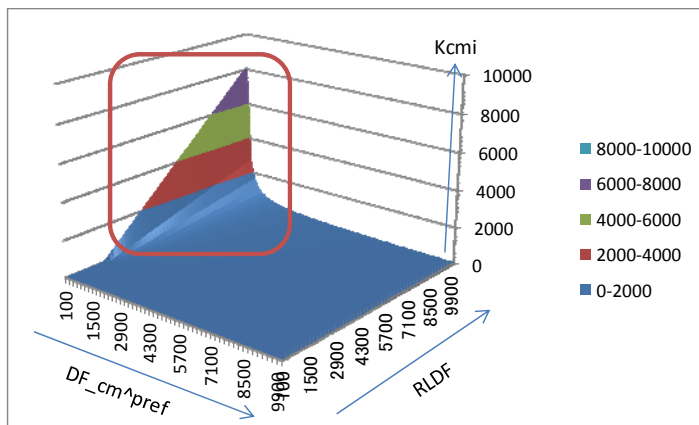
Assumption		
DF_i^pref	100	Constant
DF_ccp	2,000	Constant
RLDF	100~10,000	Variable
DF_cm^pref	100~10,000	Variable

Especially where DF_cm^pref ranges between 0 and DF_ccp, K of tranches approach becomes sharply conservative upto several times worth of capital deduction and excesses that of ratio approach.

(2) Ratio approach --- the assumption is same as (1)