November 26, 2010

Comments on "The Prudential Regime for Trading Activities: A Fundamental Review" a discussion paper published by the Financial Services Authority (UK FSA)

Japanese Bankers Association

In response to the discussion paper, "*The Prudential Regime for Trading Activities: A Fundamental Review*" [DP10/4]) released on August 25, 2010, by the Financial Services Authority, we would like to take this opportunity and put forward our comments for your consideration.

Summary

The Japanese Bankers Association ("JBA") envisages a number of problems with the proposal to apply a uniform valuation and regulatory framework to both the banking and trading books. Treating these distinct areas under a single capital adequacy rule will heighten the homogeneity of behaviour of different financial institutions, so that financial institutions will tend to take similar actions in the event of a market shock, potentially amplifying the effects of any crisis. The JBA therefore believes it would be crucial to spend sufficient time on a careful analysis as to the overall impact of this proposal. We are opposed to hasty deliberation and particular care should be taken to avoid taking action based upon an incomplete analysis given the fact that there is a fundamental review of the regulatory framework being undertaken by the Basel Committee.

The JBA believes it is of extreme importance to address the following three concerns in the context of a fundamental review of the regulatory framework.

- **Regulatory arbitrage issues should be addressed by closer supervision and monitoring, rather than stronger regulation**: Even though removing the wall between the banking book and trading book, which would be a theoretical approach, will be difficult to achieve in practice, its achievement would not guarantee a solution. It must be recognised that "perfect" regulation will never exist. No matter how stringent the new regulations may be, the problem of regulatory arbitrage will always emerge, with new distortions arising. Closer, more detailed supervision and monitoring would reinforce regulation from a different angle, and constitute an effective approach, with the potential to provide a more fundamental solution to regulatory arbitrage.

- **The costs and secondary effects of excessively stringent regulation must be taken into account:** Both excessive solutions and half-measures that do not lead to essential solutions will potentially have secondary impacts, for example, decline in financial intermediation functions. A rapid change in regulation may

also induce credit crunches and other problems with dramatic impact on the real economy.

- **Balance and priorities should be emphasised:** Understanding the fundamental nature of the problem being addressed is crucial in the review process. Complete account needs to be taken of the balance between regulatory effects including secondary impacts, with prioritised responses reflecting that balance. Regulatory reform that lacks balance or adopts mistaken priorities will fail to address the core issues, but still create secondary impacts.

Given this perspective, we believe that we can contribute more to the discussion by focusing our comments on the core, essential issues rather than responding directly to the list of technical questions posed by the UK FSA.

The JBA strongly urges that the following two points be considered.

1. The purpose of the wall between the banking book and trading book must be reconsidered and reaffirmed

Sufficient consideration should be given to the degree of harmful effect that would be caused if the wall between the trading and the banking book were to be removed. Financial institutions play the role of intermediaries of finance (by supplying liquidity to the markets and meeting customers' long-term fund-raising needs, etc.), and already assume risks as a result of undertaking this social responsibility. Haphazardly exposing such activity to fluctuations in market prices could potentially result in dysfunctional markets, and ultimately seriously damage the real economy.

Fluctuations in market prices are largely subject to shifts in the supply and demand balance. Prices in dysfunctional markets experience sharp deteriorations which do not necessarily reflect the underlying value of assets. On the other hand, assets on the banking book are primarily intended to be held to maturity, with rescue mechanisms (collection and preservation) based on the relationship with the counterparty. The potential to preserve and collect (obtain repayment) of these assets based on such relationships is of fundamental importance and constitutes the essential value, whilst a current market-price valuation is merely a supplement ancillary to this core value. Based on this, it is difficult to find any justification in pricing banking book assets in an excessively conservative manner by including market supply and demand factors

It must be kept in mind that the proposed approach is prone to amplify a crisis rather than mitigate it, as it will introduce over-reliance on market liquidity and quantification techniques. More time will be required to determine the spillover effects of mark-to-market accounting in the recent financial crisis, and consider its future role in light of what has been learned.

Meanwhile, Pillar 2 approaches of Basel Ⅱ framework have already introduced effectively functioning frameworks which address risks on the banking book such as outlier regulations. If they are to be directly captured in regulatory capital under Pillar 1 frameworks, it is imperative that a mechanism of fair, quantified valuation exists. The fact that different institutions have different approaches to managing interest-rate risks on the banking book (core deposit concepts, etc.) prove that the proposed approach does not suit a Pillar 1 framework where one-size-fits-all quantified valuation prevails. As such, it is more reasonable to handle it under the Pillar 2 framework.

Reference can be made to IFRS where classification is made according to the purpose of the holding: the "amortized cost" category and the "other comprehensive income" category. The rationale for establishing these categories supports our reasoned arguments in the preceding paragraphs and we urge the UK FSA to take full account of these. Two different valuation approaches for banks: the "going-concern price" and the "gone-concern price" are being accepted, which, as a good example, is indicating that it is meaningful to segregate assets according to the purpose of ownership.

One of the causes of the current financial crisis was that the wall between the trading book and banking book was too low. This gave room for regulatory arbitrage in which transactions that should have been handled on the banking book were instead booked on the other book without sufficient supervisory oversight. We believe that the solution to regulatory arbitrage will be found not in eliminating the wall but rather in making it higher, which should be achieved through closer supervision and monitoring by the regulators.

Having reconfirmed the necessity and significance of the trading and banking categories, we think that issues should be addressed not just by introducing new approaches, but by carefully assessing the effectiveness of existing frameworks as well as attempting to strike a balance between effectiveness and potential damage as the result of regimes being reviewed.

2. Prioritisation is required

Full consideration needs to be given to priorities in order to understand and effectively respond to the essential issues. We agree that the influence of fluctuations in market prices cannot be ignored. Fluctuations in market prices that exceed the essential value of these assets are a problem that is particularly apparent when markets are dysfunctional and the supply and demand balance is undermined. We therefore support the analytical approach presented by the UK FSA in Table 5.3.

We would direct attention to the fact that, within this analysis, the impact was particularly large on the trading book. The primary impact from the decline in market functions was felt most strongly in short-term proprietary trading and in brokerage services within the financial system. These services and activities are not suited to rescue mechanisms (collection and preservation) based on relationships with end users and, by their very nature, it is self-evident that they will be significantly more vulnerable to the influence of market volatility.

On the other hand, as described above, assets on the banking book can be subject to rescue mechanisms and preserved or collected based on relationships with the end user, even when the supply and demand balance has collapsed, and market functions have declined. In this way, the potential for preservation and collection based on relationships provides these assets with the essential value, in which market-price valuations play merely a supplementary role. Indeed, the results presented in Table 5.3 support this argument, which can be seen in the difference between the losses experienced on the trading book and banking book.

This issue also depends upon banks' business models. Considering the fact that there are differences in losses posted by banks that focus on relationship-based transactions and which have larger banking books versus banks that have larger proprietary trading books, and given the differences in losses posted by trading books and banking books themselves, we believe the priorities for capturing risk should be obvious .

We must also point out that the recent financial crisis was caused by the emergence of liquidity risk due to an over-reliance on short-term market-based fund-raising for securitised instruments and other assets with latent market liquidity risks, and not by the risk of holding assets on the banking book. In light of this evidence and the introduction of strengthened liquidity regulations, we believe that the imposing regulatory capital charges for market risk on the banking book is at odds with the purposes of these regulations and hence is not justifiable.

Meanwhile, excessive capital surcharges on banking assets will increase the volatility of assets as a whole, creating needless upheavals, potentially inducing credit crunches and exerting significant damage on the real economy.

Considering the potential damage to the real economy, the source of the problems and the possible side effects, we would like to support the approach of placing priority on consideration of capital surcharges upon the trading book, as currently defined.