November 25, 2011

Comments on the Basel Committee on Banking Supervision's Consultative Document
"Capitalization of bank exposures to central counterparties"

Japanese Bankers Association

The Japanese Bankers Association wishes to express its appreciation for the opportunity to comment on the Consultative Document, *Capitalization of bank exposures to central counterparties,* released November 2, 2011, by the Basel Committee on Banking Supervision.

However, the JBA notes that on February 4, 2011, it did offer comments in response to the first Consultative Document released December 20, 2010, but feels that those points have not been reflected enough in the second Consultative Document. The JBA encourages reconsideration of those points.

The JBA offers the following comments for consideration in regard to the Consultative Document. We hope that our comments below will assist the Basel Committee on Banking Supervision in finalizing the Proposal going forward.

【General comments】

The JBA wishes to express its agreement with the Basel Committee's efforts intended to both provide incentives for transactions using central counterparties (CCPs) while at the same time appropriately capitalize against risk arising from exposure to central counterparties.

The JBA hopes that these efforts will address the points below so that the transactions do not lose efficiency, are consistent with bank risk management practices, and function as a meaningful tool.

<u>1. Introduction of conformance period should be considered</u>

Although the second Consultative Document does mention that the start date beginning from January 2013 remains unchanged, the JBA suggests considering implementation of a conformance period. This is because capitalization of bank exposures to CCPs will not be implemented until the Basel III framework is introduced, and the preparation period for this is shorter than that of other parts of the Basel III framework. Also, the JBA seeks further quantitative impact studies (QIS) in regard to the second Consultative Document.

New systems in response to the first Consultative Document have been under development, measuring capitalization requirements for transactions with central counterparties. However, the JBA seeks flexibility in regard to implementing these new regulations, including setting a conformance period. This is because changes and/or clarifications to the second Consultative Document must be confirmed, and also because the calculation process for capitalization for default fund exposures (who provides the required data, how to confirm the calculation, etc.) has yet to be determined.

Further, the JBA believes that the impacts on risk-weighted assets from changes and/or clarifications to the second Consultative Document must be confirmed before the implementation.

2. Disclosure of CCP information needed

The qualifying criteria (eg, joint insolvency or joint default determination criteria) for default fund loss share rules and bankruptcy remoteness for margin requirements described in paragraphs 112-113 in the second Consultative Document still do not appear to describe who is to make the determination or disclose the results.

Examination and confirmation of the above, such as obtaining legal opinions from outside law firms, on the part of each individual banks and securities companies throughout the world for existing or newly-established CCPs involves duplication of work and is inefficient. Moreover, should differences arise as a result of such work among banks or securities companies regarding a given CCP, capital requirements would differ for the same CCP. The JBA therefore requests that the CCP itself or the CCP supervisory body disclose the details.

3. Calibration for calculating capital requirement based on economic reality and feasible procedures should be ensured

Although the risk weight (2%) for trade exposures with CCPs is set at a low level compared to over-the-counter (OTC) transactions, if the capital requirement for default funds is included, the total capital requirement will not necessarily be reduced. There is thus a possibility that the framework will not produce incentives for CCP transactions.

Also, not only would the framework no longer allow clearing members themselves to control the capital requirement, it cannot be considered a realistic regulation from an administrative perspective because of the heavy tasks involved when calculating capital ratios and also because collecting data from CCPs would take time.

Therefore, calibration should be based on economic reality, and feasible procedures should be ensured in calculating capital requirement.

【Specific comments】

1. K_{CCP} formula (Appendix A, Paragraph 116 (i)) should be reconsidered

The exposure amount could be excessive when calculating K_{CCP} if CEM is used. The appropriateness of the calculation method should be examined and revisited. In the K_{CCP} calculation formula, since EBRM (exposure value to clearing member 'i' before risk mitigation) is roughly the same as MTM (mark to market) before adjusted collateral amount plus PE (potential exposure), MTM before adjusted collateral amount is equivalent to VM (valuation margin). However, because the assumptions for calculating PE (potential exposure), IM, and default fund contribution differ, substantial discrepancies could arise and K_{CCP} could be excessively large as a result.

For example, while PE (notional amount * CCF(conversion factor)) increases as the number of transactions rises, IM (initial margin) and default fund contributions does not necessarily increase. Moreover, because PE is netted depending on transaction conditions, when PE against IM and default funds increases substantially, K_{CCP} becomes too large.

For this reason, the JBA seeks a review of the K_{CCP} formula.

2. Response to change in CCP status should be addressed (Paragraph 31 in original document, Paragraph 109 in Appendix)

Although the Consultative Document does describe treatment in the case of a qualifying CCP losing its status, it does not mention treatment in cases in which a non-qualifying CCP becomes a qualifying CCP. Since CCP regulations are yet to be introduced internationally, the JBA seeks clarification of the rules regarding disclosure of CCP's status and confirmation methods change, as well as treatment in terms of capitalization calculations.

3. Risk weight regarding the case when a client cannot be protected from losses in such cases that the clearing member and another client jointly default (Appendix A, Paragraph 113)

CCPs and their clearing members are responsible for separate administration of each client's account, so the 4% risk weight for the client's exposure to a clearing member is excessive. Requiring a strict client capitalization could be an impediment to an increase in users. For that reason, the risk weight should be 2%.

If the above-noted treatment is not recognized, establishing a system for clearing members would take time. Because adequate preparation time is needed, the JBA believes phased-in implementation (for example, gradually raising the risk weight, or maintaining a risk weight of 2% during the conformance period, etc.) should be considered.

4. Current Exposure Method (CEM) should be revised (Appendix A, Paragraphs 110, 116(i))

Exceptional treatment for the CEM under the current Basel II capital framework is allowed in calculating capital requirement for default fund contributions, such as raising the NGR factor from 0.6 to 0.7, or using "delta" values for the relevant options contracts in calculating potential exposures in options and/or swaptions.

Therefore, from the perspective of capital regulations regarding exposure to CCPs, the same treatment should be allowed when using the CEM for trade exposures.

5. A framework that allows clearing members to control their own required capital amount should be considered (Appendix A, Paragraph 116 (i), Graph 116 (iii))

The framework should allow each bank (including clearing members and clients) to control its own capital requirement. Because information on other CCP clearing member exposure is needed at the time when calculating K_{CCP}, the clearing member cannot control its own capital requirement, and planning their own business operations becomes more difficult. Therefore, the framework should only allow calculations based on each bank's own exposures, not on exposures at other companies.

Similarly, the proposed calculation of K_{CM} from K^*_{CM} does not allow to control our own capital requirement. Thus, an alternative approach that is not controlled by exposures on other clearing members should be permitted.

6. Minimum risk weight of 20% used in calculating K_{CCP} (Appendix A, Paragraph 116 (i)) should be reduced

The minimum risk weight of 20% is too high when calculating K_{CCP} and should be reduced. Risk weights for claims on financial institutions exposures under the Standardized Approach uniformly apply to all clearing members, but risk weights are often below 20% for bank clearing members. Also, even from the perspective of utilizing CCP in order to alleviate counterparty risk, frameworks with conservative regulatory capital treatment must be avoided.

Therefore, a desirable framework should be designed such that external ratings or banks' own approach related to calculation of credit risk capital requirement are referenced and risk weight is reduced as appropriate in accordance with the risk management capabilities of clearing members, including financial institution, which would enhance risk management practices.

7. Capital requirement exceeding K_{CCP} (Appendix A, Paragraph 116 (ii)) should be reconsidered

The JBA believes that, as shown in Case (ii) and (iii), it is too conservative to impose a capital requirement exceeding K_{CCP} for default fund contributions. When there are sufficient default funds from DF'_{CM} and/or DF_{CCP}, losses can be absorbed from existing default funds should a clearing member default.

Therefore, it is unnecessary to require regulatory capital in excess of K_{CCP}.

8. A risk weight of 1,250% to default fund contributions to a non-qualifying CCP (Appendix A, Paragraph 119) should be reduced

The 1,250% risk weight for default fund contributions for a non-qualifying CCP is too high and should be reduced. Any CCP has it own member criteria, and permits only transactions that are with the qualified clearing members. Furthermore, these clearing members are nearly equivalent to financial institutions, which are already under supervision for their respective businesses, and the 1,250% risk weight is excessively strict in comparison with a 20% risk weight for financial institutions under the Standardized Approach of Basel II framework.

Therefore, the risk weight should at least be lowered to a risk weight in line with claims on corporate companies.