June 28, 2013

Comments on the Basel Committee on Banking Supervision's Consultative Document: Supervisory framework for measuring and controlling large exposures

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the consultative document: *Supervisory framework for measuring and controlling large exposures*, released on March 26, 2013 by the Basel Committee on Banking Supervision (the "Committee").

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

General comment

○ Large exposures framework

During the recent financial crisis, corporate bond and CP markets in major countries became temporarily dysfunctional, making it difficult even for top-tier blue chip companies to secure funding through markets. In Japan, even though the impacts of sub-prime mortgage assets were relatively low, Japanese companies also faced difficulty in funding in the markets as well. It was commercial banks that fulfilled the funding needs of corporate clients using their ample pools of stable retail deposits.

- Sum of funding needs from large blue chip corporations to a certain single bank in the first three months of the crisis reached worth trillions of yen, accounted for 10% of the bank's total outstanding loans. Especially, a certain leading company requested a total of over one trillion yen of group-wide financial support to re-finance bonds or other needs, and Japanese commercial banks supported to such funding needs.

- Further, leading U.S. companies which could issue hundreds of billion dollars of bonds in normal period experienced similar funding difficulty and was supported by FDIC as well as commercial banks including Japanese ones.

Suppose this proposed regulatory framework had been in place at that time, commercial banks would not have been able to meet those demands. As such, the crisis could have been far worse and longer.

Also as the history shows, restriction on banks' financial intermediation capacity under financial crisis gives rise to the concentration of risk on the balance sheets of central banks.

Therefore, corporate exposures as well as inter-bank exposures should be subject to the framework where exceptional treatment is allowed during the financial stress.

In addition, it is also necessary to consider exemption in the case where a bank extends credit support to a financial institution that has failed or is encountering financial problems for their restructuring.

In respect of the contagion risk, we consider that Tier 2 capital has an effective loss-absorbing capacity that can serve as a buffer for senior creditors, and preventing contagion of bank defaults. Further, Basel III requires Tier 2 capital to contain written-off or conversion features so that in the event of unexpected significant loss arising from the counterparty's default, etc., and thus, Tier 2 capital will effectively function as going-concern capital in a crisis situation.

All of these points above suggest that making going concern capital as the only eligible capital base is too conservative. Giving due consideration to the role of the banks during the financial crisis and the negative effect of regulatory tightening on real economy, we strongly argue that the eligible capital base for exposure limit should be total capital.

In addition, to ensure regulatory consistency, capital (denominator) should be defined to include the capital of affiliated companies.

The Committee also proposes a tighter limit to inter G-SIB's exposure. However, given that G-SIBs are already subject to stricter regulations than other financial institutions such as additional loss absorbency requirements and recovery planning requirements, the proposed tighter limit is excessively conservative. It may become a disincentive for G-SIBs to undertake interbank transactions in the event of market freeze, resulting in unstable funding and higher systemic risk. Therefore, we can not support applying a tighter limit to G-SIBs.

○ The case for materiality-based regulation

Setting complicated rule which does not incorporate the concept of materiality under Pillar 1 imposes undue operational burden on risk management practices of financial institutions and its benefit is disproportionately small compared to its cost. In particular, applying the "granularity test" and "connected counterparties" assessment proposed under the Consultative Document to all transactions/counterparties will cause a significant burden in practice and is deemed to be unrealistic.

Therefore, the BCBS is respectfully requested to provide exemptions based on materiality, for example:

・ Granularity test:

  If a transaction accounts for 10% or less of the bank's eligible capital, such a transaction should be exempted from the granularity test and look-through approach ("LTA").

- Connected counterparties:

  If the exposure to a counterparty accounts for 1% or less of the bank's eligible capital, such a counterparty should be exempted from the connected counterparties assessment based on economic interdependence.

○ **Ensuring consistency with other international regulatory regimes**

Alignment with related regulations, especially the areas set out below, should be made in order to avoid the partial optimization of or inconsistency among regulations, overregulation, unnecessary reporting burden and other adverse consequences.

(Eliminating inconsistency among regulations)

- Ensure consistency with the existing regulatory framework for derivative exposures to promote central clearing of derivatives through CCP.
- Eliminate any factors that could be a disincentive to the holding of eligible assets (collateral) under margin requirements, etc.
- Make sure that applying the large exposures framework to interbank transactions does not harm the availability of banks' term funding which is required by the Liquidity Coverage Ratio ("LCR") framework.

(Avoidance of operational burdens such as duplicative reporting due to inconsistent definitions among regulations, etc.)

- Ensure consistency in definition with other international regulatory frameworks such as the Financial Stability Board Data Gaps Initiative ("FSB") (Reporting of I-I Data (Asset side)).

	The proposed framework (including QIS etc.)	FSB (I-I-data)
Large exposure reporting	Top 20 and more	Top 50
Sorting criteria for largest counterparty exposures	[On a gross basis] Loans + Debt Securities + Equities + CCF + Trading Book (Total Exposure) + Derivatives (Total Exposure) + Collective investment undertakings (Total Exposure) + CCP (Total Exposure)	Potential exposure ("PE") of derivatives transactions + MTM of short-term financial assets + MTM of equity investments + MTM of fixed income investments + Net Notional CDS + Net MTM CDS
Definition of loans	Item: Loans Either "Standardised Approach" or "Internal	Item: Lending (Undrawn Commitments + Funded

	The proposed framework (including QIS etc.)	FSB (I-I-data)
	ratings-based approach" is adopted.	+ Credit Reserves)
Definition of fixed income	Item: Debt Securities Either "Standardised Approach" or "Internal ratings-based approach" is adopted.	Item: Fixed Income MTM Total MTM value of debt instruments (not internal issuer risk calculation).
Definition of equity	Item: Equities Either "Standardised Approach" or "Internal ratings-based approach" is adopted.	Item: Equity MTM Total MTM value of equity (not internal issuer risk calculation).
Definition of short-term financial assets	3 months or less	1 year or less
Reporting of L/C	Reported as a CCF item in banking book off balance sheet commitments. (20% haircut is applied to L/C.)	Reported as a part of Lending.
Fixed income investment in trading book	Reported as "Debt" in trading book.	FSB does not have "banking/trading book" categories. All relevant investments are reported in the above "Fixed Income MTM".
Equity investment in trading book	Reported as "Equity" in trading book.	FSB does not have "banking/trading book" categories. All relevant investments are reported in the above "Equity MTM".
Derivatives exposures	4 categories under trading book; 1) Forwards, swaps, futures 2) Options 3) Credit Derivatives 4) Credit-linked notes	6 categories; 1) Credit 2) Commodities 3) Equity 4) FX 5) Interest Rate 6) Other
Definition of repos/reverse repos exposures	3 months or less	No specific definition in terms of maturity.

- Eliminate duplicative reporting burden in relation to the Global Trade Repository (GTR) reporting.

Specific Comments

1. The Committee welcomes views on the proposed definition of large exposures and on the proposal for reporting.

In accordance with the Basel Core Principles, most Basel Committee member jurisdictions define a large exposure threshold as 10% or more of eligible capital. The current reporting threshold (i.e. 10%) is considered to be conservative, maintaining sufficient buffer before reaching to the hard limit on exposure to the counterparty (i.e. 25%). Therefore, it is unclear why the Committee is proposing a lower threshold (i.e. 5%).

Since Basel III considerably improved the quality of capital, the scope of reporting will be significantly expanded even if the current 10% threshold is retained, compared to that under the Basel II framework, meaning that the regulation will be effectively strengthened. In addition, taking into account the increased administrative burden arising from, among other things, proposed expansion of the definition of connected counterparties as well as further strengthening of regulations, there is no compelling reason for introducing a lower threshold of 5% and thus it is considered that the current 10% threshold should be retained.

Further, the basis and objectives of requiring reporting of (1) “the largest 20 exposures,” (2) “the exposures both before and after applying credit risk mitigation techniques” and (3) “large exposures to counterparties to which the large exposure limit does not apply (e.g. sovereigns)” on an ongoing basis are unclear. Unless those are shared with the private sector, the BCBS should not impose undue reporting burdens on them.

For sovereign/PSE exposures, as it is the case for regulatory capital requirements, the existing large exposures frameworks for sovereign exposures may differ across jurisdictions where PSEs exist. Therefore, to ensure consistency in the treatment in each jurisdiction, the BCBS is respectfully requested to exclude all PSEs from the scope of the large exposures framework for now and start discussing again in line with the treatment of sovereign exposures.

Our particular concern is that, in the repo market, if the large exposures framework is applied to the securities pledged as collateral to the buyer/cash investor, it may give rise to adverse effects such as the decline in the repo market function as well as to a cumulative impacts from other initiatives to tighten regulations including the leverage ratio requirements and shadow banking regulation. Therefore, it is necessary to give due regard to the treatment of assets accepted as collateral in the repo market.

2. The Committee welcomes views on the criteria proposed for the identification of connected counterparties when they pose a single risk.

The assessment of economic interdependence largely depends on qualitative judgements and thus its implementation may vary across jurisdictions. This would run counter to the BCBS's basic approach to seek regulatory consistency internationally.

Further, the rule setting under Pillar 1 in a complicated and a 'one-rule-fits-all' manner without any consideration of materiality imposes undue burden on risk management practices of financial institutions and gives rise to an unbalanced cost-benefit equation. In this regard, it is suggested that only "control relationship" criterion should be set under Pillar 1, leaving other criteria such as economic interdependence to the discretion of bank's risk management and supervisory framework in each jurisdiction to ensure effective treatment based on materiality.

[Joint venture between two financial institutions]

In a case where a joint venture (JV) between two financial institutions extends credit to a third party, such extension of credit may be required to be included in large exposure management framework at both financial institutions and become subject to duplicative control. Moreover, lending/borrowing between a JV and one of its parent financial institutions is deemed an "intragroup credit exposure" for that institution whereas the same exposure could be deemed a "credit exposure to" or "from" the third party at the other parent financial institution.

Further if a JV obtains credit from a third-party financial institution, it would be deemed a credit exposure to two different groups under two parent financial institutions, resulting in a duplication of exposure management at such a third-party financial institution.

To avoid duplicative management of the single credit exposure or any conflicts mentioned above, it is suggested that the Committee should allow such transactions to be included in either of the parent groups depending, for example, on the level of control over the JV.

5. **The Committee welcomes views on the proposal to calculate exposure value of banks' investments in OTC derivatives.**

It is considered appropriate to exempt derivative margins required under the Margin Requirements for Non-centrally Cleared Derivatives from the large exposures framework in order to ensure consistency with the margin requirements and to avoid a cumulative impact of strengthening regulations.

Specifically, given that variation and initial margins required under the margin requirements can be offset by derivative MTM and PE respectively in the event of a counterparty's default and also are segregated from the counterparty's assets, it is not right to subject those margins pledged to the large exposures framework. Such offsetting should also be taken into account in permitting the deduction of the amount of margin Exposure at Default (EAD) from the exposure based on the Current Exposure Method (CEM).

7. The Committee welcomes views on the proposal to generally apply a 100% CCF for "traditional" off-balance sheet commitments.

Applying a flat 100% CCF to commitment lines means that the counterparty's Probability of Default (PDs) and the usage of the line at default are both assumed as 100%, which is overly conservative even for capturing tail risk. Such an excessive conservatism should be corrected by, for example, applying average percentage (based on historical data).

8. The Committee welcomes views on the proposed hybrid approach for banks that apply the "comprehensive approach" to financial collaterals.

Currently, the substitution approach and the haircut-based approach are applicable to financial collateral under the risk-based capital requirements. It is our concern that the proposed hybrid approach may lead to more double counting of credit risk compared to the current approaches, and thus adjustment should be made to prevent such a situation.

If assets pledged as collateral in the repo market become subject to the large exposures framework by applying the substitution approach or the hybrid approach, it may give rise to adverse impacts on functionality of the repo market. Therefore, the BCBS is respectfully requested to give due regard to the characteristics of products and markets and provide an option to select appropriate approaches and methods, for example by permitting the application of the haircut-based approach to low credit risk financial assets such as government bonds and mortgage-backed securities.

11. The Committee welcomes comments on the proposal regarding interbank exposures and in particular in which cases specific exemptions would be warranted.

(1) Short-term interbank transactions (i.e. overnight and other short-term transactions of around one month or less), (2) deposits for payment purposes and (3) deposits to foreign central banks should be exempted from this large exposures framework for following reasons:

- While the uncollateralized interbank market and bank reserves are closely related, and so are bank reserves and monetary policy, if short-term interbank transactions (up to one-month or so) which play a pivotal role in the money market are restricted, it would have a significant effect on market participants and undermine the orderly market operation and the stability of the short-term money markets resulting in the restriction on the transmission mechanism for monetary policy by the central bank.

- Given that banks have to maintain a liquidity buffer for projected net cash outflows during the stress period of one month mandated by the LCR requirements under Basel III, the large exposure limit should not be applied to the term funding that could be used for that buffer.
- Depending on the condition of financial markets, including above interbank transactions to large exposures framework could have negative effects on overall short term money markets, as well as smooth funding operation at individual financial institutions.
- If the large exposure limit is applied to the short-term (up to one month or so) interbank markets where the effect of credit risk factor on pricing is relatively small, a cliff effect could arise at the term threshold, distorting the yield curve formation in the markets and eventually affecting the monetary policy.
- Since it is difficult from operational perspectives to capture and report the peak exposure of the intraday interbank exposures on a global and real-time basis, requiring that could disturb payments and settlements between banks.

12. The Committee welcomes comments on the calibration of the granularity threshold and whether the mandatory application of the look-through approach to the transaction where an underlying exposure may exceed the granularity threshold will raise specific issues.

○ Look-through approach to funds and securitizations

The Committee proposes 1% of the total value of the transactions as a threshold for granularity test. However, it is not reasonable to measure concentration at the securitization transaction level given that the size of financial institutions varies.

Further, a "hard" or Pillar 1-type limit that requires day-to-day monitoring is not suitable for fund investments and securitization transactions because the reporting frequency of such transactions is generally monthly or quarterly, meaning that reporting always falls behind.

In this view, a "soft" limit or monitoring under Pillar 2, should be adopted and the granularity test should be applied based on the materiality of the collective investment undertakings ("CIU") taking into account the size of the financial institution. The following points should also be considered in order to reduce administrative burden and to avoid excessive conservatism.

- In light of the objective of the large exposures framework that is to control losses in the event of default of a single counterparty, for securitization exposures with a senior/subordinated structure, the granularity test should not be required if, for example, the single largest asset in the underlying pool is smaller than the amount of credit enhancement.
- To raise the proposed granularity test threshold from 1% to 5%.

- In practice, it is highly unlikely that all unknown exposures are related to a single counterparty. Therefore, proposed look though approach should be modified and allow certain hair-cut, for example, instead of simply aggregating all unknown exposures as if they related to the single client (i.e. "unknown client").

13. The Committee welcomes comments on the proposals for the treatment of the identified additional risks in the large exposures framework.

As the Consultative Document does not provide clear guidance for the additional risks assessment, it is difficult to ensure consistency which is one of the BCBS's objectives. Further, given concern over the possibility of double counting of risks as described in paragraph 119, we believe that Pillar 2-based monitoring should be retained for such additional risks, not Pillar 1-based approach.

14. The Committee welcomes views on the options for the treatment of banks' exposures to CCPs.

We support the second proposed option: "no Pillar 1 hard limit would apply to a bank's Q-CCP exposures." From the perspective of ensuring consistency among the regulatory objectives, promoting centralized clearing through CCP should come first, and any regulatory requirements that may create disincentive should be removed.

Further, the reporting of exposures to CCPs to supervisors can be substituted by the GTR reporting framework which is currently in the process of implementation. Therefore, considering operational burden, we respectfully request the Committee not to require individual financial institutions to report such exposures.