

July 06, 2016

Comments on the Consultative Document: *Revisions to the Basel III leverage ratio framework*, issued by the Basel Committee on Banking Supervision

Japanese Bankers Association

We, the Japanese Bankers Association (“JBA”), would like to express our gratitude for this opportunity to comment on the consultative document: *Revisions to the Basel III leverage ratio framework*, issued by the Basel Committee on Banking Supervision (“BCBS”).

We respectfully expect that the following comments will contribute to your further discussion for finalising the rule.

<<General Comments>>

1. The increase in the level of capital charges should be avoided.

The consultative document includes several proposed revisions that result in increased leverage exposure, which could effectively increase capital requirements. Also, additional requirements for G-SIBs are nothing less than an increase of the level of capital charges.

Based on the agreement by the Group of Governors and Heads of Supervision (GHOS), the BCBS has already expressed its intention to make adjustments so that a series of its regulatory revisions will not significantly increase overall capital requirements. This is supported by G20 and other relevant parties. Against such background, the BCBS should carefully calibrate overall capital requirements including this consultative document and make sure to avoid a significant increase.

2. The leverage ratio framework should be a supplementary measure to the risk-based capital framework, and should not be more binding than the risk-based capital framework.

As specified in the consultative document, the objectives of the leverage ratio are

to restrict the excessive build-up of leverage in the banking sector and to reinforce the risk-based capital requirements with a simple, non-risk-based backstop measure.

The more binding non-risk-based leverage ratio framework would not only disincentivize banks from enhancing their risk management activities, but also erroneously incentivize banks to reduce low-risk assets and take on high-risk assets in order to pursue higher return. It means that risk sensitivity which the BCBS recognises as an important element of the regulatory framework would be lost.

Currently, however, the leverage ratio has become more binding than the risk-based capital ratio for many banks and more than a “backstop” measure. Under the non-risk-based leverage ratio framework, profitability of low-risk and low-margin transactions, such as repo, call loan and plain vanilla derivatives, tends to look relatively unfavorable, which could adversely affect the liquidity of capital markets and inter-bank transactions. This could also be a constraint on market-making activities since financial institutions would reduce their inventories in bonds. While these negative effects have actually been observed since the start of the leverage ratio disclosure, the increase in the leverage ratio exposure measure and the additional requirements for G-SIBs proposed in the consultative document are highly likely to aggravate such a situation.

The consultative document also proposes to incorporate the CCFs for off-balance sheet items under the revised standardised approach for credit risk into the leverage ratio framework. However, it would not be appropriate to set the same CCFs for the risk-based standardised approach and the non-risk-based leverage ratio. Given that the leverage ratio serves as a backstop to the risk-based capital ratio, CCFs for the leverage ratio framework should be lower than those for the risk-based standardised approach for credit risk. Further, since commitments, in particular, include various types of products, appropriate treatment based on their respective characteristics should be introduced.

Additionally, in reviewing the leverage ratio framework, the BCBS should also give adequate consideration to: (i) conflict with the liquidity and other requirements; and (ii) consistency with the TLAC framework.

- (i) The leverage ratio framework will give banks incentives that contradict to the Basel III liquidity coverage ratio and derivatives margin requirements that require banks to hold high quality liquid assets including government bonds

and cash. If the leverage ratio becomes more binding the conflict between these frameworks will be worsen. Also, while the liquidity requirement framework was designed to incentivize banks to beef up stable funding (e.g. retail deposits), the leverage ratio framework will impose capital charges on the increased balance sheet with retail deposits. As such, the leverage ratio should not become a binding constraint.

- (ii) Under the TLAC rules applicable to G-SIBs, minimum requirements are established based on the leverage ratio exposure measure. Therefore, an increase in the leverage ratio exposure measure would substantively increase the TLAC minimum requirements. In this view, the BCBS is respectfully requested to give due regard to the concern that the impact of revisions to the leverage ratio framework on the TLAC requirements could be significant.

3. We strongly oppose to additional Basel III leverage ratio requirements for G-SIBs, above the 3% minimum.

As mentioned above, the Basel III leverage ratio should serve as a backstop measure to the risk-based capital requirements. Essentially, additional leverage ratio requirements on G-SIBs would be a backstop to the backstop measure, redundant framework, and therefore is considered to be unnecessary.

In addition to risk-based capital surcharges imposed on G-SIBs, supervision of G-SIBs has already been significantly enhanced in accordance with the FSB's recommendation *Intensity and Effectiveness of SIFI Supervision*. From this viewpoint, any additional requirements on G-SIBs would be excessive and unnecessary.

Furthermore, "total exposures as defined for use in the Basel III leverage ratio" is reflected in determining G-SIBs and is assigned the indicator weighting of 20% which is the highest among individual indicators. Therefore, it is likely that banks with large total exposures used in the Basel III leverage ratio will be designated as a G-SIB and thus will be subject to capital surcharges.

In that sense, the risk-based capital framework already incorporates adequate disincentives for increasing leverage exposures. Therefore, to impose additional leverage ratio requirements on G-SIBs is duplicative and excessive, not aligned with the

BCBS's objectives to establish a simple leverage ratio framework.

<<Specific Comments>>

1. CCFs for off-balance sheet items

As discussed in the General Comments section, we oppose the proposal to incorporate the CCFs for off-balance sheet items under the revised standardized approach for credit risk into the leverage ratio framework.

With respect to the definition of commitments included in the off-balance sheet items, we support the idea of maintaining consistency with the standardised approach for credit risk but strongly oppose to the definition of commitments which is based solely on the existence of any contractual arrangement with clients as proposed in the BCBS's consultative document: *Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches*. Since commitments include various types of products, treatment appropriate to their respective characteristics should be introduced. Further, from the perspective of ensuring consistency with accounting treatment, the scope of the definition of commitments should be limited to those disclosed in financial statements.

The CCFs for off-balance sheet items should be determined according to characteristics of exposures. In particular, commitment related transactions should be classified into "general commitments", "unconditionally cancellable commitments" and "non-commitments" based on the three conditions as specified in the table below: (i) possibility of unconditional cancellation by the bank; (ii) receipt of commitment fees; and (iii) the bank's approval before drawing commitments.

Table: Classification of commitment-related transactions

Classification of transactions	Conditions			Proposed CCF (under the standardised approach)	(Reference) Applicable products in Japan
	Unconditionally cancellable?	Receipt of any fees?	Whether the bank's approval required whenever using a credit line		
General commitments	No	Yes	Not required	50%	Commitment line
Unconditionally cancellable commitments	Yes	No	Not required	Decrease the CCF level for corporates at least to the same level as the CCFs for retail	General bank overdraft
Non-commitments	Yes	No	Required	0%	Special bank overdraft

Then, “non-commitments” that satisfy all of the three conditions should be excluded from the leverage ratio exposure measure. With respect to those contracts satisfying all of the three conditions above, since banks do not have any obligations to extend credit to clients, it would be inappropriate to treat such arrangements as commitments simply by virtue of the existence of contracts. Under these arrangements, clients apply to the bank for loans before the drawing and the bank determines whether the application for the drawing can be accepted. As with the case of general new loan arrangements, the bank may decline the drawing for whatever reasons.

In Japan, the purpose of the use of unconditionally cancellable commitments for corporates is mainly to provide funds for their settlement purposes. Under such commitments, the bank permits an overdraft of the client's current account (i.e. the use of credit line) to address the client's temporary mismatch in funds. However, this product generally serves as a backstop, and the bank does not receive any commitment fees from clients and can reduce, suspend or terminate the credit line at its discretion when the client's creditworthiness deteriorates. In practice, the bank has in place a

process where it restricts withdrawal, reduces or cancels the credit line and considers and demands additional collateral to be posted before the client defaults when there is any indication of deterioration in the client's creditworthiness, and shifts to normal loans (e.g. loan on deeds) if the use of the commitment line continues for a long time. As this process is the same as unconditionally cancellable commitments for retail clients, it is not reasonable to differentiate the treatment of commitments between corporate clients and retail clients. Rather, for corporate clients, it is easier for banks to timely recognize the situation of clients in details and to promptly identify deterioration in their creditworthiness, when occurred. Therefore, risks associated with corporate clients are mitigated relative to those for retail clients.

Please note that the CCFs shown in the above table are our proposed CCFs to be applied under the standardised approach for credit risk, and that the CCFs for the leverage ratio framework should be lower than these CCFs.

2. Additional Basel III leverage ratio requirements for G-SIBs

As commented in the General Comments section, additional Basel III leverage ratio requirements should not be imposed on G-SIBs. If, however, they are determined to be introduced, the scaling of such add-ons under the leverage ratio framework should be in line with the G-SIB surcharge framework in order to ensure consistency with such a framework which is already introduced in the regulatory capital framework. It would not be reasonable to set a uniform add-on. Furthermore, in order to ensure regulatory simplicity, it would be more appropriate to treat such add-ons as a buffer, similarly to G-SIB surcharge, and include them in the Tier 1 capital requirement.

With respect to the level of such add-ons, a proposed level would be the amount derived by multiplying G-SIB surcharge under the regulatory capital framework by 0.35 which is the ratio defined for capital requirements of 8.5% (i.e. Tier 1 minimum capital requirement of 6% + capital conservation buffer of 2.5%) applicable to all banks subject to international standards for the minimum requirement of 3% for the leverage ratio.

This approach is consistent with the idea of treating the leverage ratio framework as a backstop to the risk-based capital framework.

However, if this consultative document is implemented as proposed, it will significantly increase the denominator of the leverage ratio, combined with the CCFs

for the off-balance sheet items under the revised standardised approach for credit risk and the application of the SA-CCR to derivative exposures. As a result, the leverage ratio is likely to aggravate. If the additional requirements for G-SIBs are implemented from January 2018, since the significant amount of reduction of loans or disposal of assets takes place in a short timeframe in order to maintain the leverage ratio, the real economy or financial markets may be negatively affected.

In view of the above, the BCBS is respectfully requested to provide a sufficient period of time for preparation if it determines to impose additional Basel III leverage ratio requirements on G-SIBs. At least, phase-in arrangements need to be applied, consistent with the G-SIB surcharge under the regulatory capital framework.

3. Others

(1) Regular-way purchases and sales of financial assets

Option B should be adopted and an offsetting treatment should be allowed for certain accounts.

Under regular-way purchase/sale contracts of securities, “accounts receivable-securities trading account” and “accounts payable-securities trading account” are used as accrued accounts when the time frame between the trade date and the delivery date established by market rules or convention is a general period¹. As amounts recorded in these accounts substantially represent an amount to be settled, such accounts are recorded only for a very short period and exposed to significantly low settlement risk. In this view, these accounts basically have equivalent nature as cash. Also from market liquidity and other perspectives, it is considered as reasonable to allow offsetting for these accounts.

(2) Currency mismatch

We oppose to the application of an FX haircut when there is a currency mismatch between cash variation margin and termination currency under derivative transactions. The treatment is already sufficiently conservative in that conditions for cash variation margin to be eligible for reducing the replacement cost include: (a) the currency of cash

¹ A general period is four business days or shorter which does not fall under the category of long settlement trades defined under the Basel regime.

variation margin should match the settlement currency; (b) such cash variation margin is not subject to segregation; and (c) such cash variation is covered by the master netting agreement. To add a requirement regarding the termination currency to these conditions would be an over-regulation.

In the first place, introducing different currency mismatch treatments in the margin requirements and the leverage ratio requirements would undermine the BCBS's focus to enhance simplicity of regulatory frameworks.

<<Other comments>>

Assets related to trust account activities should be excluded from the exposure measure in the leverage ratio.

Trust banks (including trust banks to which trust banks entrust management of trust assets ("sub-trustee")) hold and invest third-party assets in trust accounts, such as pension funds and investment trusts, and undertake the settlement and management functions of securities. In fulfilling such duties, a part of those assets are generally set aside as surplus funds in preparation for payments of pension benefits and redemption and for future investment purposes. These surplus funds are generally invested in money markets, such as the call market, directly from the trust account.

However, as a result of intensive monetary easing, the function of such money markets has declined, making it difficult for trust banks to investment surplus funds in the money markets. Such surplus funds are now retained in the central bank's current account (i.e. funds are included in the denominator for the leverage ratio calculation purposes) from trust banks' trust account via banking book².

Trust banks are required to invest and manage in line with the purpose of the trust. Surplus funds are generally expected to be invested in the money markets in order to secure liquidity³. As a consequence, trust banks are experiencing an increase in exposure measures under the leverage ratio framework beyond their control.

² Since trustors, such as pension funds and investment trusts, are not qualified for opening a current account in the Bank of Japan, funds need to flow through trust banks' banking book.

³ In particular, in the case of investment trusts, investment trust management companies have the investment discretion and trust banks can only invest and manage trust assets based on instructions from the investment trust management companies.

The objective of implementing the leverage ratio framework is to “restrict the build-up of leverage in the banking sector” and is not to restrict asset investment and management functions in the trust business. From this viewpoint, assets managed under business activities relating to the trust account should be excluded from exposure measures for the leverage ratio calculation purposes.

Appendix. Illustrative explanation of a trust bank

