May 14th, 2001

Secretariat of the Basel Committee on Banking Supervision

Dear Sir/Madam,

The Japan Center for International Finance is pleased to send to the Secretariat of the Basel Committee on Banking Supervision the following comments addressing "The New Basel Capital Accord" (hereafter referred to as the "New Basel Accord") which was made public last January by the Basel Committee. These comments incorporate the opinions of Japanese financial institutions and other informed parties.

Yours sincerely,
Rei Masunaga, Deputy President
Masayuki Tanaka, Senior Economist

COMMENTS ON "THE NEW BASEL CAPITAL ACCORD"
─ The Market Consultative Paper by the Basel Committee on Banking Supervision ─

General Remarks

The New Basel Accord in essence recommends that banks maintain a detailed grasp of risk, rigidly review their lending requirements in favor of "management toward quality," and work to adopt a framework characterized by high risk sensitivity. As a method of calculating credit risk, regardless of using either the standardized approach or the internal ratings-based approach, the Accord deserves a high evaluation insofar that changes are made in weighting in response to asset risk characteristics, an approach which is in line with the internal controls adopted by major Japanese banks. At the current point in time, the major banks and a number of regional banks in Japan are scheduled to use the internal ratings-based approach, while small and medium-sized banks will be adopting the standardized approach.

In the New Basel Accord, the level of capital adequacy is proposed to be generally unchanged in comparison to the current status when viewed as a whole. In fact, it is considered that the capital requirement and capital cost of Japanese banks will only be slightly impacted when adopting the standardized approach, with such impact decreasing slightly when the internal ratings-based approach is put into place. However, when capital requirements are also keyed to operational risk, many Japanese banks have expressed concern that their capital cost may rise.

Hence, while the concept of the New Basel Accord in itself is supported by Japanese banks, many point out the increased burden on the actual business front. First, due to the Basel Committee's decision to defer adoption of the portfolio model this time around, there are some banks for which the need has emerged to iron out inconsistencies between their own internal risk management system and the method adopted in the New Basel Accord which could give banks the burden of duplicated investment. Second, small and medium-sized banks view in-house deployment of the statistical model as a difficult proposition, particularly in view of the cost of obtaining capable personnel, the challenge of gathering data, and other factors. While they understand that the internal ratings-based approach will provide advanced risk management methods, it will take some time before they can introduce and make effective use of such methods.

Impact on the Lending Stance of Japanese Banks

Under the current situation, in which Japan's prolonged deflationary economy has resulted in poor development of the capital base of Japanese banks and a decline in their lending function, there are fears that applying the stipulations of the New Basel Accord all the way through to small and medium-sized banks might lead to a credit crunch for many small and medium-sized businesses which are principal customers of these banks and which could be assigned low credit ratings under the proposed system. In fact, as long as the traditional lending practices in which the deposit-

lending spread is not necessarily set in response to risk, it cannot be denied that excessively cautious approaches could be adopted on extending credit to companies with lower ratings or higher probability of default (PD). While acknowledging the benefits of the New Basel Accord, many banks wonder how, under the new rules, room for maneuvering can be assured in determining their lending policy, taking also stock of so-called 'relationship banking' which is deeply rooted in Japan.

Default Reference Definition

Under the New Basel Accord, when banks internally compute PD, the default reference definition proposed here must be used. Also, the Accord recommends that PD for internal ratings be adopted as an important factor in credit risk pricing, determination of strategic resource allocation, adoption of incentive-based compensation plans, and other bank management procedures. As a result, once the default reference definition is given, that will have an extensive impact on the management of a bank. The attempt to create common default criteria which are applicable to the banks of different countries is theoretically correct. However, as of today, the definition of default cannot easily be reconciled among countries and also among banks, as each bank has its own definition of default which is used for internal ratings and credit model simulations. On the other hand, recently, default rate presumption models and other similar concepts are being supplied by credit rating companies, consulting companies, and credit risk model supply companies in various parts of the world. Taking the above factors into consideration, it is expected that more studies will be undertaken to reach a consensus on a definition of default reference acceptable to most banks of different nationality.

Calculation of Risk Weighting Under the Internal Ratings-Based Approach

The use of PD-sensitive risk weighting is an appropriate method for computing overall risk, while coefficiencies and other settings which are used in the risk weighting exposure for business enterprises seem to be too conservative. Whether LGD (loss given the default), after consideration of credit complementation through collateral, guarantees and credit derivatives, as well as M (maturity) and other prerequisites are appropriately incorporated in the proposal is questioned. Also, as a countermeasure for conservative setting, the need for conservative setting of the parameters within a theoretical approach N(x) (cumulative distribution function for a standard normal random variable) may be worthwhile studying.

Retail Exposure Standards

In the New Basel Accord, with regard to retail portfolios containing loans to individuals or small and medium-sized businesses, a proposal is made to lower the capital adequacy requirement. In order to meet this capital requirement, it is requested that the following segmentation be made: (1) by product type, (2) by borrower risk, (3) by delinquency status, and (4) by vintage. The first two must be satisfied by all banks, while the other two must also be complied with unless a bank can satisfy the authorities that they are inappropriate. With regard to such segmentation, particularly that by borrower risk (2), it is pointed out that actual business practice in retail transactions is by the pooling of diversified individual exposures, so that this proposal for grading individual

transactions within a segment is incongruous with actual market practice.

Lending Granularity Effects

Because banks need to have economic capital to cope with portfolio risk, high marks are given to the positive effects of small-lot diversification (granularity effects), which incorporate the risk diversification effects as a portfolio. However, in the process of calculating granularity adjustment, a need is noted in the Accord for measurement of exposure concentration for credits receiving the same internal rating. In this connection, it is proposed that in cases when two of the obligors have strong mutual relations and high default correlation, the two parties should be treated as a single obligor. Although this proposal is theoretically correct, it is pointed out by some banks that the need to compile a roster of obligors will create an additional work burden. Also, banks which have conducted trial calculations of risk weighting reduction effects under the formula indicated in the New Basel Accord point out that only limited reduction effects are obtained compared with application of the CreditMetrics™ based method.

Difficulties for Japanese Banks in Adopting Advanced Methods Under the Internal Ratings-Based Approach

Indicated under the internal ratings-based approach are two methods ─ the "basic" approach and the "advanced" approach. Examining these two methods, even for Japanese banks possessing sophisticated risk management methods, the hurdles for introducing the advanced approach are particularly high because of insufficient data. To adopt the advanced approach, in addition to estimates of LGD, the New Basel Accord also requires estimates of EAD (exposure at default). It is also expected that those estimates cover the entire business cycle which must never be shorter than seven years. However, with regard to Japan, which experienced a rather unusual stagnation period in the1990s after the bursting of the bubble economy, there is concern whether the record of the last seven years can represent appropriate data for LGD or EAD. Also, due to the fact that LGD is attributed not to accounting losses but rather "economic losses", the adoption of the advanced approach requires an information system different from those used to date by Japanese banks. In view of the cost, feasibility, and other factors, immediate introduction of this approach is considered to be difficult.

Treatment of Stocks which are held for special purposes

Under the internal ratings-based approach presented in the New Basel Accord, it is proposed that PD be used for stockholdings in the calculation of risk weighting (as it is with lending), with the possibility of capital adequacy requirements being held low for the stocks of blue chip companies. In Supporting Documents, it is also proposed that the market risk method be used in calculating capital adequacy requirements for stocks held in bank accounts, because there are banks which stress the importance of the risk of stock price declines and which actually conduct economic capital calculations and allocation based on the level of market risk.

Although Japanese banks are currently unwinding crossholdings, it is still widely considered that because these equities were originally obtained for the purpose of long-term ownership they do not

fit well with risk weighting through the market risk approach. As a result, it might be better to deal with the issue of stockholdings either through adoption of mark-to-market accounting rules or the supervisory review process (Pillar 2 of the Accord Framework). More basically, there is a view that as the purpose of credit ratings is to come to a judgment on timely payment probability, the concept of stock ratings should be entirely different from that of credit ratings.

Operational Risk Evaluation

Based on samples from advanced banks, the New Basel Accord estimates that operational risk is an average 20 percent of economic capital. The majority of Japanese banks feel that this is excessive. This is because Japanese banks consider that they are reducing operational risk by bearing higher precautionary expenses in daily operations, system maintenance, and personnel costs than banks in the US and Europe. In addition, the "floor" concept of expressing a minimum below which required capital will not fall is introduced in the Accord. It was pointed out, in this connection, that this could have adverse effects when viewed from the perspective of risk management incentives. Also, the role of operational risk insurance is not adequately taken into account in the Accord. Overall, it would be preferable to have a more sophisticated process for calculating capital requirements in response to operational risk.