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Opinion paper on the New Basel Capital Accord

Japanese Bankers Association

In January 2001, the Basel Committee on Banking Supervision (the "Basel Committee") released *The New Basel Capital Accord*, the second Consultative Document to revise the regulatory capital framework for banks.

The Japanese Bankers Association welcomes the Basel Committee's ongoing efforts to reform the regulatory capital framework. We strongly support the increased emphasis on banks' internal risk management and market discipline and the creation of a regulatory environment more conducive to the utilization of banks' internal risk management practices through providing a more extensive menu of approaches.

In reviewing and responding to the Consultative Document, we considered especially the need to:

establish a risk-sensitive framework;

create a regulatory environment more conducive to banks' internal procedures, thereby enhancing the quality of risk management;

set appropriate overall capital requirement levels;

ensure a level playing field among banks and between banks and non-banks; and

reflect the different financial business practices of each country in an appropriate manner.

In addition, we took into account our own experience in Japan with respect to the macroeconomic effects implicit in capital adequacy regulation.

In this opinion paper, we have listed a number of our concerns and recommendations, based on the key considerations listed above, and identified areas that we believe need to be revised. We hope that the Basel Committee will consider seriously our recommendations and incorporate them into the final Accord. The key to successfully completing the current review process is to maintain a close dialogue between the supervisory authorities and the banks, and we look forward to continuing discussions with the Basel Committee.

Pillar 1: Minimum Capital Requirements

1. Standardised Approach

- The following changes should be made to ensure that the capital charge under the Standardised Approach remains neutral compared to the current regulatory capital charge.
  a) Risk weights for the retail portfolio should be reduced in line with the treatment under the Internal Ratings - Based (IRB) Approach.
  b) A 100% risk weight should be applied to the unsecured portion of any asset that is past due for more than 90 days, net of specific provisions.

<u>Neutrality relative to current capital requirements</u>

* The Consultative Document clearly articulates that *"the Committee desires neither to produce a net increase nor a net decrease – on average – in minimum regulatory capital, after accounting for operational risk"* (neutrality vis-a-vis current regulatory capital). It has also been proposed that an amount equivalent to 20% of current regulatory capital should be allocated to operational risk. This means that the risk-weighted assets calculated under the new Standardised Approach will have to be reduced to 80% of the current risk-weighted assets.

* However, we strongly doubt whether the currently proposed set of risk weights can achieve the level of reduction mentioned above. As a large number of banks around the world are expected to adopt the Standardised Approach, it is essential that the capital requirements of these banks should not be increased from the current level.

<u>Modification of risk weights</u>

* To achieve neutrality relative to current capital requirements, we believe it is necessary to reduce risk weights of retail portfolios, in line with the treatment under the IRB Approach. In addition, increased recognition of credit risk mitigation techniques will also be required. (See below for detailed discussion.)

* A 100% risk weight should be applied to the unsecured portion of any asset that is past due for more than 90 days, net of specific provisions.

* A risk weight category of 75% should be established between the current 50% and 100% categories.

Consistency with internal risk management practices

* Banks are required to *"use the chosen ECAIs (External Credit Assessment Institutions) and their ratings consistently for both risk weighting and risk management purposes."* This requirement should be eliminated because there are reasonable cases in which banks use external ratings to measure risk weights but use internal ratings for purposes of internal control. Banks seeking to transfer to an IRB Approach at some point in the future would be the typical case.

2. Credit risk mitigation techniques

- The recognition of credit risk mitigation techniques should be altered as detailed below to make the new framework risk-sensitive and consistent with banks' internal risk management. The current Consultative Document does not provide sufficient incentives for banks to transfer from the Standardised Approach to the IRB Approach.

  a) Second or subsequent charges on real estate collateral must be included in eligible physical collateral.

  b) The LGD floor of physical collateral must be lowered to the same level as financial collateral.

  c) The "w" factor should be eliminated.

Need to increase the recognition of collateral and guarantees

* In order to make the new regulatory framework more risk-sensitive, it is extremely important to correctly recognize the risk-mitigating effects of collateral and guarantees. In this respect, the Consultative Document leans excessively towards financial collateral in its treatment of collateral recognition and gives less attention to the value of physical collateral. By introducing this sort of bias into the recognition of specified types of collateral within the regulatory framework, there is a danger that the new Accord could, for example, distort the business of taking collateral and/or pricing loans, thereby affecting the behavior of banks and corporations.

* Furthermore, from the standpoint of providing sufficient incentives for banks to transfer from the Standardised Approach to the foundation IRB Approach, it is of particular importance to expand the recognition of collateral and guarantees in the IRB Approach. When a bank transfers to the IRB Approach, the risk weights of borrowers rated BB or below will increase substantially. However, since this is the area in which risk mitigation by collateral and guarantees is most frequently used, it should be possible to establish a suitable incentive by adequately recognizing the risk mitigation effects of these items.

<u>Extending the recognition of real estate collateral</u>

* We strongly request a change in the treatment of real estate collateral in extending the recognition of qualifying physical collateral.

* First, the requisite qualifications for recognition as physical collateral must be eased to enable the recognition of second or subsequent charges on real estate. There are cases in which the amount taken as first-charge collateral is small compared to the total value of the real estate, and a large amount is leftover for subsequent charges. In such cases, it is quite conceivable that a second-charge mortgage could prove to be sufficiently secure. The limited recognition in the current proposal will reduce the incentive to take collateral and impair consistency between regulatory and internal risk management practices.

  The following formulae should be used to assess the collateral value of second or subsequent charges:

  H: The value of real estate after being given its haircut (revalued at least once a year)
  C1: Value taken as first (or subsequent) charge(s)
  C2: Value taken as the charge in question
  M: Credit risk mitigation effect of collateral C2

  (1) Where H   C1 + C2: M = C2
  (2) Where H < C1 + C2: M = H - C1

* Second, the framework for the treatment of real estate collateral must be brought into line with that of financial collateral. We find no rationale for treating collateral with a coverage rate under 30% as uncollateralised. To create a risk-sensitive regulatory

framework, the risk mitigation effects of collateral must be recognized regardless of the rate of collateral coverage. In addition, as the liquidity of collateral could be reflected in the rate of the haircut, there would be no reason to distinguish between physical and financial collateral when assigning LGD values, and each should be treated in the same way.

<u>Elimination of 'w' factor</u>

* A problem that affects all risk mitigation techniques is the w factor (the 0.15 floor). It should be eliminated for the following reasons:

* The rationale for setting the w factor to 0.15 is not clear and is, as such, unsuitable for inclusion in a risk-sensitive regulatory framework. If w is intended to compensate for fluctuations in collateral recovery rates, it will inevitably vary depending on the types of collateral. For this reason, it should be reflected in the haircut rate. We believe that it would be overly conservative to apply w across the board after haircuts have been given to collateral values.

* The Consultative Document is already on the conservative side with respect to guarantees in that it uses a PD replacement method even though losses are likely only if the main borrower and the guarantor default at the same time. Therefore, it would be overly conservative to apply w to guarantees.

* The introduction of w will cause serious conflicts with banks' own internal risk management procedures. Because there is no reason to apply such an overly conservative procedure to internal risk management, banks would be forced to spend significant operational costs and to invest in information systems solely to meet regulatory requirements while maintaining their current procedures for internal purposes.

3. Internal Ratings-Based Approach

(1) Capital requirement levels

- Reductions in risk-weighted assets of 2% to 3% are intended when banks transfer from the Standardised Approach to the foundation IRB Approach. However, we strongly doubt whether the intended reduction could be achieved under the current proposal. In addition, we believe that the incentive value of 2% to 3% reductions is largely insufficient. To address these concerns, we would advocate the following actions:

- The risk weight curve should be flattened. The two multipliers in the benchmark risk weight function (PD measurement error and Tier 2 adjustment) must be eliminated.

- The results of the Quantitative Impact Study (QIS) should be made public. Enough information must be provided to ensure that the overall level of capital under the new Accord is set as proposed.

<u>A. Problems caused by an excessively high capital requirement</u>

<u>Effects on bank management</u>

* The current benchmark risk weight function proposed in the Consultative Document could result in a year-on-year fluctuation in risk-weighted assets of 10% or more, even under normal economic conditions. This would seriously destabilize the banks' management environment.

* A clear distinction must be made between minimum regulatory capital requirements and the optimal level of capital that financial institutions should seek to achieve.

<u>Effects on the business cycle</u>

* Capital adequacy regulations are generally said to amplify the business cycle. This procyclical nature could become much more pronounced under the new Accord, since risk-weighted assets are expected to increase significantly during an economic downturn. The negative aspect of the new Accord on economic activity could extend well beyond the Basel Committee's expectations.

* It appears that the Basel Committee is seeking to resolve this problem by introducing a through-the-cycle IRB Approach that is forward-looking and hence not seriously affected by the business cycle. However, we believe there is very little chance that this approach will actually work. It is easy to employ conservative reserving policies and ratings during an economic expansion, but once the economy enters a downturn, it would be very difficult in practice to ease these standards. On the contrary, in fact, it has clearly been the experience of many countries that a conservative approach to the setting of reserves and ratings tends to be called for during economic downturns thus making a difficult economic situation worse.

<u>Insufficient incentive to transfer to IRB Approach</u>

* The Basel Committee intends to reduce risk weighted asset values by 2% to 3% when banks transfer from the Standardised Approach to the foundation IRB Approach. However, it is certain that the proposed benchmark risk weight function would produce much higher capital charges. This gives banks little incentive to allocate management resources for the purpose of transferring to IRB Approach.

* Transferring to the IRB Approach would also increase the risk weights allocated to customers rated BB or below, a primary source of business for commercial banks. As those same customers will be allocated fixed risk weights under the Standardized Approach, little incentive exists for banks to transfer to the IRB Approach given that they will have to continue competing with banks that are still using the Standardised Approach.

<u>B. Problems with the benchmark risk weight function</u>

* The benchmark risk weight function contains two adjustment factors, namely the PD measurement error adjustment factor and the Tier 2 capital adjustment factor, that apply loads of 1.2 and 1.3 respectively across the board. These multipliers make the slope of the risk weight curve steeper and, in so doing, amplify business cycle fluctuations and increase managerial risks for banks.

* The application of these two multipliers is overly conservative, and their theoretical basis is doubtful, if not simply incorrect. The introduction of an across-the-board load factor results in a bias towards high-rated borrowers because the steeper curve

unnecessarily favors borrowers with high ratings while allocating unduly high-risk weights to lower-rated borrowers. Therefore, we strongly request these two multipliers to be eliminated.

PD measurement error

* Errors or volatility in PD estimates are themselves "risks" which models seek to quantify, and it is theoretically incorrect to anticipate errors in the input to models.

* If the Committee's concern lies in the fact that "the banks may be consistently underestimating PD by a fixed amount," it should be dealt with through minimum requirements for use of the IRB Approach and follow-up checks implemented as part of the second pillar.

* On the other hand, if the intention is to account for statistical error associated with PD estimates, the amount of correction required should vary depending on the credit rating of the borrower in question -- the higher (lower) the credit rating, the larger (smaller) the correction. A 20% across-the-board increase in the capital requirement would be inappropriate in that it would, in effect, create a reverse correction.

Tier 2 adjustment

* The Basel Committee has taken the view that the capacity of Tier 2 capital to absorb losses is more limited than that of Tier 1 capital, and it has applied a multiplier of 1.3 to account for this difference. This is inconsistent with the Committee's statement that *"the definition of capital is not being modified."*

* The difference of loss absorption capacity between Tier 1 and Tier 2 capital is already reflected in the numerous disadvantages in the way Tier 2 capital is treated compared to Tier 1 capital, such as the limitations in inclusion to total capital. To recognize even greater "differences" is equal to modifying the definition of regulatory capital.

* One reason stated for a regulatory capital charge against EL + UL is the incorporation of general loan loss reserves into Tier 2 capital. Hence, the loss absorption capacity of general loan loss reserves is deemed to be equal to that of Tier 1 capital.

C. Quantitative impact study (QIS) and the determination of "neutrality relative to existing capital requirement"

* The assessment of neutrality vis-a-vis current regulatory capital and the sufficiency of incentives to transfer from the Standardised Approach to the IRB Approach must be based on careful and thorough surveys.

* Under the new regulatory framework, risk-weighted assets are expected to fluctuate significantly depending on the state of the economy and on the nature of a bank's business. Therefore, it is important to ensure that calibration exercises are not based on the results of surveys limited in terms of time or scope. On its own, the current QIS is insufficient to present a clear picture of the likely effects of the new regulatory requirements, and it should be carried on continuously until 2004. In addition, it is necessary to go back for at least 10 years and study the impacts under the worst economic conditions. To improve the precision of its results, the QIS should also be carried out on a large number of banks in as many different countries as possible.

* The Basel Committee is responsible for proving that the new Accord does not result in a net increase or a net decrease in minimum capital requirements. The results of the QIS must be fed back to the banking community as soon as possible.

(2) Conditions for transferring to a more advanced approach

- As it would be unrealistic to require banks to transfer all their portfolios on a fully consolidated basis from the Standardised Approach to the IRB Approach, we recommend the following measures:

  a) Requirements to use the IRB Approach should be eased according to the "principle of materiality."

  b) Some rules of reason should be crafted to permit partial use of both the Standardised and IRB Approaches.

- To ensure that banks have an incentive to move from the foundation IRB Approach to the advanced IRB Approach, we suggest:

  a) Easing the 7 years data holding requirement.

  b) Permitting partial use of both foundation and advanced approaches by different portfolios.

* Partial use of both the Standardised and IRB Approaches is not recognized, presumably due to concerns about cherry picking. While we understand this concern, we feel that the Committee is being excessively rigid in seeking to prevent cherry picking by refusing to recognize partial transfers. We believe that this will ultimately limit the number of banks that choose to adopt an IRB Approach. Certain subsidiaries should be allowed, for example, to remain in the Standardised Approach since if the "principle of materiality" or some rules of reason apply, the problem of cherry picking will not occur.

* Minimum requirements for the advanced IRB Approach are extremely rigorous, and only a small number of banks are expected to use this option when the new regulatory framework goes into effect in 2004. Though the requisite data collection systems will require huge investments, use of the advanced IRB Approach will not be permitted until seven years worth of data have been collected. Such requirements weaken incentives to collect data.

* To make the new regulatory framework risk-sensitive and to provide the banking community with suitable incentives to enhance its risk management procedures, the standards for recognizing an advanced IRB Approach should be relaxed.

* More specifically, instead of requiring seven years worth of recovery rate data in every case, the number of years for which data must be collected should vary depending on the type of collateral (for example, seven years worth of data is not necessary for main index equities). The use of data from a variety of different external sources should also be recognized, and various mapping procedures should be permitted. Furthermore, the policy of refusing to recognize the use of an advanced approach until the requisite recovery rate data has been collected for every portfolio must be revised to enable partial use of internal LGD values in selected portfolios or types of collateral.

(3) Definition of default

- Since the definition of default is different in every country, mapping against the reference definition formulated by the Basel Committee will be inevitable. Flexible mapping methods should be permitted.

* We understand the need to craft a reference definition of default as a precondition for the use of an IRB Approach. However, this definition must at all times be confined to its use as a standard for the calculation of regulatory bank capital. There is no need for the same definition to be used by banks worldwide for internal control purposes.

* Individual banks should be allowed to choose the definition of default that best suits their internal control purposes. Therefore, flexible acceptance of mapping between default rates based on banks' internal definitions and those based on the reference definition should be permitted. Qualification standards for this mapping exercise should be entrusted to the authorities in the countries concerned. Also, the requirement to use the reference definition for internal control purposes should be removed (Rules Book, paragraph 289).

* Because the reference definition will be the most important factor in the IRB Approach, it must be objective and allow for consistent application in different countries. The definition of distressed restructuring, which necessarily involves subjective judgments, must therefore be re-examined including the possibility of not incorporating this element.

* The way in which the term "default" itself is used widely differs from country to country. Changing the term "default" in the reference definition should also be considered.

(4) Treatment of defaulted loans

- To ensure that regulatory treatment will not discourage banks from dealing with defaulted loans in a timely fashion, either of the following treatments should be taken:

  a) Separate defaulted loans from the benchmark risk weight function and apply a single risk weight.

  b) Make adequate adjustments such as deducting the total risk weighted asset value of defaulted loans subject to provision.

* We strongly oppose to the proposal to deal with defaulted loans by allocating a risk weight of 625% to exposures net of charge-offs and specific provisions. This method does not recognize the coverage of expected loss of the net exposures, and as the Basel Committee itself has acknowledged, it reduces incentives for banks to charge-off or set aside reserves in a timely and appropriate fashion.

* Treatment of defaulted loans varies between countries, depending on accounting and supervisory standards. In some countries strict reserving policies are set so that banks are required to make conservative loan loss provisions above the level of expected losses. Capital requirements against defaulted loans cannot, therefore, be calculated by means of a single function and should be set using a different framework from that used for normal claims. Especially in countries where the authorities have established conservative reserving standards, a uniform risk-weight should be considered for defaulted loans. This issue could possibly be left to the discretion of national regulators.

* It would also be possible to make adequate adjustments, such as deducting the total risk weighted asset value of defaulted loans subject to provision. If such an approach were not permitted, banks in countries with conservative reserving standards would be disadvantaged and this would create problems from the standpoint of level playing fields.

(5) Retail portfolios

- In order to accurately reflect the risk profile of retail portfolios and at the same time maintain the consistency of the whole regulatory framework, we believe that:

  a) The risk weight function should take account of the lower asset correlation of retail business.

  b) Both retail and corporate portfolios must be treated under a consistent risk weight function.

  c) Too many segments should not be created, and internal segmentations should be recognized so as to incorporate various national variations.

* Retail portfolios have a lower risk profile than corporate portfolios because they are diversified and have low asset correlation. We agree with the proposal to make the new regulatory framework risk-sensitive by establishing a risk weight function for retail portfolios separate from that used for corporate portfolios.

* However, consistency must be maintained in handling each portfolio under the IRB Approach to ensure that banks are neither advantaged nor disadvantaged by the characteristics of their loan portfolios. The lower risk profile of retail portfolios

should be taken into account by reducing the correlation factor of the risk weight function. Approaches that treat retail portfolios totally differently -- by, for example, setting capital charges only against UL -- must be avoided to ensure the framework's overall consistency.

* Various types of segmentation are specified as minimum requirements, but these standards must be flexible since individual banks are likely to choose different segments depending on the overall scale of their business and their risk profile. We believe that, aside from those related to product categories, few segments should be required.

(6) Equity

- As stated in the Consultative Document, equity portfolios should be treated under the following approach:

  a) A "PD/LGD approach" should be used for equities held for strategic purposes (i.e., to promote a long-term relationship).

  b) In the case of equities held for short-term capital gain purposes, either a "PD/LGD approach" or a "market risk / stress testing approach" should be used.

* There are substantial historical and systematic differences between countries in the structures of financial intermediation, and it would be inappropriate to charge regulatory capital for equity portfolios under a uniform rule without taking into consideration these differences. Different treatments should be applied based on the purposes for which shares are held, as has been proposed in the Consultative Document. For assessing regulatory capital against strategic shareholdings, a "PD/LGD approach" would be appropriate. For equities held for short-term capital gains, either a "market risk / stress testing approach" or a "PD/LGD approach" -- whichever is appropriate under the circumstances -- should be applied.

* Under the PD/LGD approach, equities would be treated as "loans" with an LGD of 100%. This will enable all corporate exposures to be handled within the same framework.

* Determining a workable definition of default for equities would be necessary to apply the PD/LGD approach to equities. As we propose this approach to be applied to equities that are held for strategic purposes, it would be reasonable to assume the

existence of other credit transactions against the same customer. Therefore, an event of default in any of the other transactions would work as a definition of default for equities. The application of this definition could be difficult in cases in which an obligor is not assigned a rating or no other credit transactions exist. Despite these problems, however, if a bank makes a decision to invest in a certain equity, then it is also likely to be monitoring the issuer’s progress fairly closely, and this should make it possible both to assign a rating and to recognize a default when it occurs.

(7) Maturity

- To ensure consistency with banks' internal risk management and to create a more risk-sensitive regulatory framework, the following procedures related to maturity should be used:

  a) Maturity must be taken clearly into account in the foundation IRB Approach.

  b) Adjustments should also be carried out for maturities shorter than one year.

* Maturity is an important component of credit risk, and many banks reflect this in their credit pricing. To create a risk-sensitive regulatory framework, it would be necessary to reflect the effects of maturity.

* Providing data for maturity would not be an additional burden for most banks. There is thus no reason to confine reflection of maturity to the advanced IRB Approach and it should also be taken into account in the foundation IRB Approach.

* An MTM mode maturity adjustment of one to three years is incorporated in the benchmark risk weight function. Therefore, in order to reflect maturity, the necessary adjustments must be made using the results of MTM mode calculations (Supporting Document explaining the IRB Approach, paragraph 177, Table 4.). Even if different adjustments were used, adjustments under three years must be made by using the MTM mode to maintain the consistency of the regulatory framework. Otherwise, the maturity adjustment term in the benchmark risk weight function must be changed.

* In order to reflect short-term credit risk accurately in the regulatory framework, the maturity adjustment should be extended to below one year (down to one month, for example).

(8) Granularity adjustment

- We support a granularity adjustment but request the adoption of the following procedures to reduce the workload associated with implementing the adjustment.

- Flexible approaches for exposure aggregation, such as recognition of groups based on individual banks' internal standards, should be permitted. Exposure aggregation will place additional strain on information systems and increase banks' workload.

* Concentration and diversification is an important element of credit risk that is recognized by many banks in their internal models. We agree with the use of the granularity adjustment to ensure the creation of a risk-sensitive regulatory framework.

* However, the calculation of aggregated exposures for all large-scale borrowers on a fully consolidated basis would not only place a huge burden on banks' information systems but would also entail substantial ongoing maintenance costs due to changes in the borrower groups. Since all banks are likely to have their own internal procedures for recognizing borrower groups for internal control purposes, the banks' various approaches should, with the approval of the authorities, be recognized within the terms of the new regulatory framework.

4. Capital charge assessment basis (EL + UL)

- Because accounting standards vary between countries, it is an acceptable solution to charge capital on both expected losses (EL) and unexpected losses (UL).

* As there are differences between accounting standards across countries, it would be impossible to assume that EL is fully covered by general reserves. Consequently, if regulatory capital were charged against UL only, and general reserves were excluded from the capital base, banks in different countries may be advantaged or disadvantaged according to the differences in their countries' accounting standards. Assessment of regulatory capital charges should thus be based on the combination of EL plus UL as it is under the present framework.

5. Asset securitization

- Given the various stages of development of asset securitization markets in different countries, particular care must be taken to ensure that the treatment under the new Accord will not impair the ongoing development of these markets. At least the

following revisions should be made.

a) The risk weights allocated to securitization instruments under the Standardised Approach must be the same as are allocated to corporate claims.

b) Securitization of a bank's claims should at least not increase its regulatory capital requirement.

c) Securitization of assets other than pooled claims, where underlying assets continue to be managed as individual loans, should be treated in the same way as ordinary corporate business loans.

d) The definition of *"implicit recourse"* must be clarified, and penalties should not be imposed in cases in which there are reasonable grounds.

Recognition of the utility of securitization and the different characteristic features of individual country markets

* We understand the concern that some current securitization activities may in practice be used to evade regulatory capital charges. We nevertheless feel that the Consultative Document has been overly conservative in its treatment of securitization. We must recognize the major contribution made by the development of asset securitization markets to the fundraising and financial restructuring activities of business corporations and banks.

* We must also be aware that there are differences in the development levels of different countries' markets. The Consultative Document seems to be directed at markets in which there are many investors with different risk appetites and various debt structures can be created. While such markets would be able to cope with the tightening of the regulatory framework, in countries such as Japan where asset securitization markets are still under-developed and where banks hold large quantities of subordinated debt, implementation of the regulatory framework described in the Consultative Document would impede the development of these markets.

* The virtues of securitization should be recognized, and we request that due care be taken in formulating the new regulatory framework to ensure that banks are neither advantaged nor disadvantaged by differences in the degree of development of their domestic markets.

Risk weights under the Standardised Approach

* Securitization instruments should be risk weighted in the same way as claims against business corporations under the Standardised Approach. We see no reason to treat rated securitization instruments differently from their underlying assets, which are usually corporate and retail claims. Though a conservative treatment may be justified against unrated securitization instruments, rated instruments have already been subjected to rigorous stress testing.

Securitization of own-bank claims

* We would request that the securitization of own-bank claims should at least not increase a bank's regulatory capital requirement. In other words, the maximum capital requirement should be 8% of the risk-weighted assets calculated by either the Standardised Approach or the IRB Approach. Moreover, even if only limited recognition can be given to the risk transfer effect on the senior portion, in the event that the subordinated portion subject to capital deduction was sold, the risk transfer effect should then be recognized.

Securitization of assets other than pooled loans

* If, after securitization, underlying assets continue to be managed as individual loans, they should be treated in the same way as ordinary corporate business loans under both the Standardised Approach and the IRB Approach. In other words, in addition to permitting liquidity facilities to be treated in the same way as ordinary corporate commitment lines, they must also be risk weighted by reference to the ratings of the underlying assets.

Implicit recourse

* Although the Consultative Document establishes extremely harsh penalties for banks found to have provided implicit recourse, the criteria on which such judgments will be based are not made sufficiently clear. It is our hope, therefore, that the Committee will define more specific and objective criteria for determining implicit recourse. The imposition of penalties must be confined to cases in which banks have sought to evade regulatory capital charges and dispensed with in cases, for example, recourse at

face value in the event that there is a breach of duty under the terms of a warranty, or recourse at a fair market value where there were reasonable grounds.

6. Operational risk

- Capital requirements for operational risk must be risk-sensitive to account for differences among banks in terms of, for example, risk profiles or efforts in curtailing risk.

* The three approaches for measuring operational risk outlined in the Consultative Document, namely the Basic Indicator Approach (BIA), the Standardised Approach (SA), and the Internal Measurement Approach (IMA), are intended to provide an increasingly risk-sensitive regulatory framework for banks as they adopt more sophisticated approaches. To encourage banks to enhance their risk management procedures and use more sophisticated approaches, adequate incentives must be created, by ensuring that capital requirements are reduced as a bank proceeds within the spectrum.

* It is important for the exposure indicator (EI) to be made risk-sensitive, particularly for the IMA. In other words, the EI must not be simply a scaling factor but must itself be exposed to operational risk. If the definition is formulated improperly, it will create the wrong incentives for the management of operational risk. If asset size is chosen as the EI for all business lines, it will restore the capital charge for operational risk to something akin to the current credit risk framework. The EI must therefore be defined in a manner appropriate to operational risk. In the case of commercial banking or retail business lines, for example, "transaction amounts" would be an appropriate EI. We also hope that there will be a study based on the practicalities of the situation such as whether or not a definition can be formulated, given the limited time available, and whether the requisite data can be collected.

* The allocation of an explicit capital charge for operational risk is something new both for the supervisory authorities and for the banks, and a careful survey must for this reason be carried out to ascertain the size of the annual fluctuations in bank capital requirements that would result from application of the different approaches. We would suggest, moreover, that the final parameters not be determined this year but only in response to the results of several consecutive years' surveys.

Pillar 2: Supervisory Review Process

- We support the Basel Committee's intention to place increased importance on the qualitative aspects of bank supervision through the use of "Pillar 2". Banks' capital adequacy should not be measured only by a uniform quantitative criterion but also through a variety of qualitative considerations.

- It should also be noted that the implementation of "Pillar 2" will be accompanied with increased discretion of supervisors. Care must be taken to guard against excessive intervention in the management of individual banks and against the danger of impairing level playing fields.

* The Consultative Document lists eight items of "*supervisory response*" if the supervisors "*become concerned that a bank is either not meeting*" or "*is at significant risk of not meeting*" two requirements, namely, "*to have an adequate process for assessing their overall capital adequacy*" and "*to operate above minimum regulatory capital ratios.*" However, "*restricting the payment of dividends and/or executive bonuses*" or "*requiring that senior management and/or the board be replaced*" before a bank falls below its minimum capital adequacy level, constitutes excessive intervention in banks' activities. These provisions should be removed.

* The Consultative Document calls for "transparency" and "accountability" on the part of the supervisory authorities and we would suggest that a mechanism should also be established to enable individual banks to object in the event that they find themselves the subject of discretionary measures.

* There is a danger that the establishment of levels of regulatory capital higher than the minimum capital adequacy ratio will lead in practice to an increase in the minimum ratio. There is also a risk that the capital adequacy ratio, which is ultimately only one of a number of indicators, will be mistakenly understood to be of overriding importance. Regulatory capital levels higher than 8% should not therefore be introduced as an international standard at this stage.

* At the same time, care must be taken to ensure that differences in the way in which the authorities in different countries impose the Pillar 2 do not impair the level playing fields of banks in each country.

Pillar 3: Market Discipline

- We fully recognize the need to increase transparency by banks.

- However, the items cited in the Consultative Document are both too broad and overly detailed. Items that need to be disclosed for the purposes of capital regulation must be kept to the minimum to ensure international comparability and consideration is necessary on the significance of disclosure items, the increase in burden, and the importance of maintaining a level playing field.

- The decision whether or not to disclose a broader range of items in greater detail should be left to the judgment of individual banks.

* The increased role of market discipline within the new Accord necessitates increased disclosure by banks.

* However, the items disclosed should be only those necessary to assess the capital adequacy of individual banks. We believe that those cited in the Consultative Document are overly broad. The market is comprised of a broad spectrum of participants, ranging from depositors and general creditors to subordinated creditors and shareholders, each of which requires different types of information. There is thus a wide variety of information required by the "market," but there is no need for all of it to be subject to general disclosure. There are also many items that would involve the disclosure of a great deal of detailed technical information. Many of the statistical quantities used for the measurement of risk would be difficult for anyone other than experts to fully understand. While it is important that the basic import of these data should be made accessible to the public, it is difficult to see how disclosure of the technical and specialist data reported to the supervisory authorities would help market participants evaluate a bank's performance.

* With that said, in order to prevent misinformation in the market, the number of items that need to be disclosed for the purposes of capital regulation should be limited according to the principle of materiality. In determining which items should be disclosed, it is important to consider the significance of each item, the increased burden on the banks to comply with additional disclosure requirements, and the importance of maintaining a level playing field. Furthermore, the disclosure items must be kept to the minimum needed to ensure international comparability.

* The decision of whether or not to disclose a broader range of items in greater detail than is required by the regulations must be left to the judgment and devices of individual banks. Market participants would benefit if individual financial institutions determined the level and content of disclosure consistent with their internal control methods. In principle, banks should look to the markets to determine the requisite level of disclosure. There is no reason at this stage for the authorities to step in and set a detailed agenda for disclosure since there is every reason to assume that the markets will set minimum disclosure standards of their own.

* Standards for disclosure are determined not only according to the regulations set by the bank supervisory authorities but also in accordance with financial accounting standards. As for the frequency of disclosure in Japan, it is considered to be sufficient for the banks to undertake full disclosure at least twice a year as part of their interim and annual closings. When discussing the content and frequency of disclosure, it is essential that consistency should be maintained between these standards.