Comments on “The New Basel Capital Accord”
(The Second Consultative Document on Revision of BIS Standards)

The National Association of Shinkin Banks

The Second Consultative Paper on “The New Basel Capital Accord” (hereinafter called “Accord”) released by the Basel Committee on Banking Supervision is based on a more flexible concept than the present. It aims to shift the emphasis of management to one that is focused on internal risk management of financial institutions and market discipline, and to enable a risk management approach of financial institutions to be applied by the regulatory supervising administration. A considerable understanding may be given to this change of direction.

However, the following are a few considerable issues from the viewpoint of Shinkin Banks, which are regional cooperative financial institutions that do not engage in complex operations.

1. The Basic Position of the Shinkin Bank Industry

The Small and Medium-sized Business Financing in our country has the following features:

1 Financial documents such as the settlement reports are not fully provided, and the actual conditions make it difficult to adopt a strict internal rating-based approach.

2 It has a strong personal financing characteristic, which attach importance on the assets and qualifications of the manager. It has a large weighting of risk assets secured by real estate and or personal guarantees.

3 Since it is strongly affected by the economy and by other factors, the performance of the company is monitored through daily contacts. The loan

period and the interest rates are often revised and rescheduled (extension of loans, reduction and exemption of interest rates) judging from the standpoint of business continuance and development.

To apply The New BIS Standard to these financial institutions, does not suit the actual conditions of financial transactions, and will result in an excessive and ineffective risk management system that would be unfit for the risk profile.

Therefore, it is best if the Accord is applied in principle to internationally active financial institutions. Separate rulings should be arranged by the supervising authorities to ensure sound management of regional cooperative financial institutions as the Shinkin Banks.

2. General Remarks

(1) Verification of Influence Toward Economy

Capital adequacy ratios have been used as indicators to the soundness of a financial institution, and have enjoyed a certain amount of reputation in doing so. However, bankruptcies have occurred despite sufficient capital adequacy ratios. Standard regulation imposed without any given consideration to the economic conditions has resulted in a credit crunch. These examples have illustrated a flaw in the application of the capital adequacy ratio, and its validity to be used as an indicator.

Especially, since the Accord (internal rating-based approach) has higher risk sensitivity than the present, it is expected that the capital adequacy ratios will be more largely influenced by the economic cycle. Thus, the Accord should provide a balanced solution that ensures smooth financing and sound management of financial institutions at times when the economy is on its down trend.

(2) Basic Position on Minimum Regulatory Capital

The Accord states that, "the Committee desires neither to produce a net increase nor a net decrease – on average – in minimum regulatory capital of internationally active financial institutions." However, when the standardised approach is adopted by a financial institution whose credit exposure is held with non-rated small and mid-sized businesses and individuals, an increase in minimum regulatory capital is expected due to the added operational risks, despite the fact that the weight of credit risk remain mostly unchanged. Therefore, consideration should be given so that the above basic concept of the Accord holds true for financial institutions under the standardised approach.

3. A Standardised Approach Toward Measuring Credit Risk

(1) Management of Retail Assets

Consideration should be given so that the effects of risk diversification of such retail assets as exposures toward small and mid-sized businesses and individuals, also be reflected for those financial institutions adopting a standardised approach.

The diversification effects of these retail assets may be considered to be statistical rather than a result of advanced risk management. Therefore, the same effects may be applied to financial institutions adopting standardised approach, in addition to those adopting the internal rating-based approach.

Also, the fact that the definition of retail exposure is very narrow may pose a problem. As previously mentioned, the risk diversification effects of retail assets are very statistical, and therefore it may be possible to be determined

separately from the categories of product types under the Accord.

Risk Mitigation Through Risks Secured by Real Estates and Personal Guarantees

Under the standardised approach, the incentive toward mitigating credit risks (credit risk mitigation effect through risks secured on real estate and guarantees by persons) is smaller than that of internal rating-based approach. However, these credit risk mitigation incentives should also be applied under the standardized approach, and the various conditions among the countries should also be reflected.

1 In Japan, mitigating credit risks by securing them with real estate or having them personally guaranteed are actually carried out as credit risk controlling methods.The relevancy of the assessment (appraisal standard with consideration to risks associated with fluctuation in prices) is checked by the supervising authorities through on-the-spot inspections.

2 In Japan, based on the financial inspection manuals announced by the supervising authorities, each financial institution determines its own assessment standard, depreciation and provision standards, to check its assets at the end of each business term. However, although risk mitigation through risks secured by real estates and personal guarantees is considered as a valid method in these assessments, the capital adequacy ratio is calculated using a separate standard which limits the use of these methods. This points out an inconsistency between the assessment, depreciation/provision, and capital ratio calculation.

3 Regarding measures against credit loss risks that arise out of uncertainty of small and mid-sized businesses, business conditions will be monitored from time to time, and the claims will be secured by real estates and personal guarantees when necessary. This is highly important in controlling credit

risks. The credit risk models should reflect such monitoring and valuation on collateral and personal guarantees.

4. Operational Risks

To reflect operational risks on minimum regulatory capital is logically understandable. However, if the approach to measuring credit risks is not yet established, it should be left to the discretion of each country's supervising authorities under the second pillar, rather than the first.

5. The Third Pillar, Market Discipline

The Accord's contents regarding enhanced disclosure of financial institutions is fully understandable. However, items presented in the Accord are very technical and specialized, that it may be difficult for the customers of Shinkin Banks, the small and mid-sized businesses and individuals, to understand. The essential purpose of disclosing information is to enable the readers, the customers to understand the management conditions of the financial institution. It should not be something that needs to be explained by economists or other specialists.

6. Others (Application of Models)

There are two options presented as approach to measuring credit risks, the standardised approach and the internal rating-based approach. Regarding the internal rating-based approach, by using a common credit risk model, there is a possibility that the model may become quite different from each country's financial practices, and the risk profiles and risk management actions of each financial institution. Therefore, consideration should be given toward a more flexible model, which includes such factors as the complexity and

advancement of businesses of each institution, and as the type of customers that it serves (The models should include a definition of default for the various customer types).