The Norinchukin Bank

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Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

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Dear Sirs:

The Norinchukin Bank, the central bank for Japan's agriculture, fisheries and forestry cooperatives (hereafter "the Bank"), appreciates the opportunity to respond to the consultative document, The New Basel Capital Accord (hereafter "the New Accord"), and its supporting documents.

The Bank is appreciative of the substantial efforts made by both the Basel Committee on Banking Supervision (hereafter "the Committee") and national supervisors in supporting an improved capital adequacy framework.

The Bank wishes to offer the following comments on matters that are deemed important in reflecting the views of the Japanese primary-sector cooperative banking community, with an overall deposit base of approximately Yen 70 trillion.

General Discussion

(1) Risk Assets

The New Accord attempts to improve the precision with which banks measure their risk assets, and adopts a reductionistic approach to the measurement of various risks. The Bank agrees with the Committee that the new capital framework is more risk sensitive than its predecessor is.

However, the Bank is concerned that, as discussed in the following sections in greater detail, the proposed framework incorporates certain variables that are not symmetrical as a result of regulatory conservatism. An overly conservative regulatory framework lowers banks' risk tolerance levels, driving them excessively risk averse, for example, in times of economic downturns.

The Bank, therefore, believes that particular attention should be paid to whether the proposed framework achieves an appropriate equilibrium between banks' ability to bare risks and required level of regulatory conservatism.

(2) Minimum Regulatory Capital vs. Capital in Excess of the Minimum

Pillar 2 of the New Accord proposes that the supervisors should have the ability to require banks to hold capital in excess of the regulatory minimum under Pillar 1. The Bank is of opinion that the treatment of Pillar 2 capital, including interest rate risk in the banking book, should be granted maximum national discretion for the following reasons:

(a) Once over the required minimum, the determination of the appropriate level of capital is derived from a bank's business strategy, and thus rests primarily within the realm of corporate management. The effective supervision of Pillar 2 capital, then, is best conducted by national

supervisors having a thorough understanding of the processes of corporate decision making in their jurisdiction.

(b) Legal framework for the implementation of banking supervision varies across countries and is not globally uniform. The national supervisors should have the ability to reflect on the most effective methods to treat the Pillar 2 capital in consultation with the banking industry under their supervision.

The First Pillar: Minimum Capital Requirements

(1) Internal Rating-Based Approach Benchmark Risk Weights

The Bank notes that the Committee has made a conscious decision that the benefits of a more risk-sensitive framework outweigh the potential of amplifying business cycles (Overview, paragraph 40). In this connection, the Bank is concerned about the following two aspects of the proposed framework:

(a) The benchmark risk weights, proposed in the Internal Ratings-Based Approach, are particularly conservative (high). The basis of our observations is as follows:

(i) These benchmark risk weights have been calibrated by the collected data that reflect relatively favorable world economic conditions then prevailing, linking a given probability of default to a risk weight that is otherwise excessive under the average economic conditions.

(ii) These benchmark risk weights, judging from the proposed formula for calibration (Accord, paragraph 174; IRB, paragraph 163), also seem to have been adjusted upwards for unspecified regulatory reasons.

The Bank is concerned that, as a result of the conservative adjustment to the calibration of risk weights, the overall minimum capital requirements for banks may be increased, in spite of the Committee's explicit statement of its desire neither to produce a net increase nor a net decrease in minimum regulatory capital, after accounting for operational risk (Overview, paragraph 46).

(b) The overall conservative risk weights not only raise capital requirements for banks but also induce banks to be excessively risk averse as opposed to risk sensitive. As a result, any future downturn in the world economy, temporary or prolonged, is likely to be exacerbated through possible credit crunch and/or a less stable financial system.

The Bank is of opinion, therefore, that the benchmark risk weights should be calibrated with caution, so that they are not overweighed by undue regulatory conservatism.

(2) Minimum Requirements for PD Estimation for Sovereigns and Banks

The New Accord sets minimum requirements for estimating PD's for corporate exposures (New Accord, paragraph 274), and then extends them to sovereign and bank exposures respectively (New Accord, paragraphs 480 and 496). The Bank believes that, given limited sample of sovereigns and banks, certain amount of flexibility should be allowed in the estimation of PD's for sovereign and bank exposures.

(3) The Standardised Approach

Option 2 under Claims on Banks incorporates a rule for reduced risk weights applicable to original maturity of three months or less (Accord, paragraph 32). While the Committee claims that the upper maturity bound in the short-term inter-bank market is generally three months (Std App Sup, paragraph 27),

the level of activity in the inter-bank market changes substantially in response to the liquidity requirements among the banks, as well as the state of national economy.

The three-month maturity cut-off not only reduces the stability of the funding banks, but also prevents the lending banks from providing liquidity evenly across the short-term maturity spectrum, lowering the overall liquidity level of the inter-bank market. The Bank is of opinion that it should be extended to one year in consideration of these factors.

(4) Risk Mitigation Techniques

The Committee's proposal to recognize a range of risk mitigation techniques is incentive compatible, instrumental in facilitating credit risk management practices in banks, and thus highly welcome. However, the Bank has concerns in connection with the followings:

(a) Use of "w"

The Bank finds it difficult to justify the role for "w" in this framework. The rationale for "w" as expressed by the Committee is attributed to the residual risks in connection with the type of collateral used and/or documentation and controls (Std App Sup, paragraph 154). Nevertheless, the reasoning is unclear and confusing, particularly when considering haircut adjustments being made concurrently.

In addition, "w" makes the complex risk asset calculation processes even more complex and costly for banks, while the incremental information value that results from incorporating "w" into the calculation is minimal to the calculating banks, investors and national supervisors. The Bank is of opinion that "w" should not be included in the proposed framework, as the costs apparently outweigh the potential benefits.

(b) Residential Real Estate (RRE) & Commercial Real Estate (CRE)

In connection with these collaterals, the Committee requires, as a part of the operational requirements for eligible recognition, a first lien on, or charge over, the collateral (Accord, paragraph 320). The Bank believes that it is only economically rational, and schematically consistent, to recognize collateral with a second lien as eligible as well.

(5) Asset Securitisation

The New Accord treats securitized assets conservatively. The Bank supports the Committee's view to applying a strict set of requirements to the recognition of a "clean break" (AS Sup, paragraph 9). The Bank also agrees that the prudent treatment of asset securitization is an integral and indispensable part to the overall effectiveness of the new framework.

The Bank, however, finds it difficult to understand the rationale that investing banks also are penalized with higher risk weights for acquiring these assets that already qualify for a "clean break", and thus believes that the treatment of securitized assets should be consistent with corporate exposures.

(6) Operational Risk

The operational risk framework is an evolving risk management regime, and requires continuous data collection on the part of the banks across various business lines. The priority at this stage should be placed on facilitating this process, and to that end, a flexible regulatory approach is necessary. The Bank is of opinion that certain flexibility should be

allowed as to the scope of risks to be covered under operational risk as well as the definition of business lines.

The Second Pillar: Supervisory Review Process

Requiring Pillar 2 capital in addition to Pillar 1 capital obscures the boundary between regulatory supervision and a bank's business decision making. More specifically, the introduction of target/trigger ratios (New Accord, paragraph 628) complicates the issue for the following reasons:

(1) Banks set a target capital ratio that aims at optimal capital structure based on their management objectives. Supervisory target ratios above the required minimum may restrict these management objectives.

(2) Setting target/trigger ratios on top of the required minimum capital (8%) effectively undermines the role of Pillar 1 capital.

(3) Treatment of target/trigger ratios in connection with Pillar 3 disclosure has not been addressed.

The Bank believes that, because of these intricate issues to be clarified, the treatment of Pillar 2 capital requirements should be handled carefully by the national supervisors on the basis of national discretion.

The Third Pillar: Market Discipline

The New Accord promotes enhanced disclosure on the concept of the "rational investor" test (New Accord, paragraph 115). While the Committee argues that the New Accord maintains a proper balance between the need for meaningful disclosure and the protection of proprietary information (Disc Sup, paragraph 21), the proposed set of outputs is overly detailed and thus obscures the original purpose of such disclosure.

The Bank believes that an exhaustive disclosure does not necessarily provide a bank's risk profile effectively or efficiently, and therefore, the scope and depth of disclosure should be streamlined on the basis of the bare minimum required by the "rational investor".

Sincerely,

Hirofumi Ueno
President

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Please feel free to contact Nori Sato, Senior Manager, Corporate Planning Division, at 81 3 5222 2032, or norisato@nochubank.or.jp, if you would like to discuss our views.