June 14, 2001
Rating and Investment Information, Inc.

Comment on The New Basel Capital Accord

1. Rating and Investment Information, Inc. (R&I), has a favorable evaluation of The New Basel Capital Accord (the New Accord) in that it aims at a more elaborate method of credit risk management regarding the first of the three mutually reinforcing pillars it enumerates, *minimum capital requirements*, and also in that it allows the introduction of new credit risk management methods such as the use of an internal ratings-based (IRB) approach. Another favorable development is that the third pillar, *market discipline*, calls for greater reliance on market functions, for example through more thorough disclosure.

2. R&I believes that the eligibility criteria for external credit assessment institutions contained in Paragraph 46 of the New Accord are appropriate guidelines. R&I expects that not only will Japan's financial authorities adopt these criteria in full, but that other countries will also base their confirmation procedures for external credit assessment institutions solely on these criteria.

3. The General Rules of the Standardized Approach for credit risk contained in Paragraphs 22 to 40 set the risk weight for non-rated assets at 100%. It seems that there were heated discussions on treatment of non-rated assets during the process of drafting the New Accord, and R&I would like the Basel Committee to clarify that non-rated assets are not recommended, by precisely explaining the reasons for this conclusion and the process of examination from numerous angles.
R&I would also like Option 2 of Paragraph 32 to be investigated with a view to revising it, since by giving a weight of 150% to assets rated below B- but a weight of 50% or 20% to non-rated assets it appears to be too generous toward non-rated assets even in view of the above factors.

4. Regarding the Foundation methodology for IRB approach examined in Paragraphs 150 to 234, R&I is under the apprehension that the risk assets calculated according to this methodology will be higher than the risk assets calculated by using the Standardized Approach, and that it will thus fail to accomplish the policy objective of the New Accord to encourage the adoption of a more sophisticated approach to risk management.
Supposing a virtual bank whose whole portfolio consists of short-term and long-term lending claims to all the listed companies in Japan (3,423 corporations excluding banks, securities and insurance companies for fiscal 2000), we compare the size of risk assets of this bank calculated according to the Foundation IRB Approach[*1] with what is calculated by using the Standardized Approach[*2] as described below respectively.

**1* *First, we classify all the lending assets into Internal Rating grades by applying "RADAR (TM)", the rating estimation statistical model[for Japanese corporate [maybe]] developed by R&I, to the above mentioned listed corporations. RADAR can provide us with 20 Internal Rating Grades (from "aaa" to "d").*
Secondly, we estimate the probability of default (10-year average default) associated with

every grade of the Internal Rating. This definition of default, i.e. legal bankruptcy proceedings plus mergers for bailout, is narrower than that in Paragraph 272, so a stress of three times has been applied to the above probability of default. According to the research conducted by R&I, the probability of default in Paragraph 272 is likely to be three times as large as this narrowly defined one.

Thirdly, we calculate the risk-weighted assets based on these probabilities of default and the benchmark risk weight in Paragraphs 174,175 and 176.

**2 On the same assumption as stipulated above, we calculate the risk-weighted assets, applying the External Ratings provided by R&I to all the listed corporations in Japan.*

Using the Internal Ratings of the RADAR model in place of R&I ratings, we obtain the size of the risk-weighted assets, that is 80.28, which is almost the same as calculated according to the Foundation IRB Approach.

As the results of the two approaches, we have obtained 83.03 for the Foundation IRB approach and 74.53 for the Standardised approach [100 is the size of risk assets when the risk weight of all the assets is regarded as 100%.] The former is considerably greater than the latter. This suggests that the benchmark risk weight for corporate exposures as defined in Paragraphs 174, 175 and 176 is set at a rather conservative level overall, and that the discrepancy against the creditworthiness of banks' actual portfolios is too large. R&I believes that this point should be reconsidered from a more realistic viewpoint and suggests that it may be necessary to disclose the data on which the equation was derived and review the benchmark risk weight settings again.

5. In the same way, the risk weight for retail exposures given in Paragraphs 426, 427 and 428 should also be revised accordingly.

6. Regarding the minimum requirements for mapping internal grades to external data sets as outlined in Paragraphs 278 and 279 and the minimum requirements for use of the statistical default models in Paragraphs 280, 281 and 282, R&I expects that a practical examination can be conducted as soon as possible and its results disclosed immediately. There is not a substantial accumulation of PD data in Japan, so it is necessary to set up systems and start preparing data presently.

7. Regarding the risk weight for securitization tranches outlined in Paragraph 526, it appears at first glance that there is an imbalance as against the risk weight for general corporates. If this higher risk weight for securitization tranches has been set to anticipate the scale of losses that would emerge in the event of changes to the legal framework that supports the certainty of the cash flow in the securitization structure, it can be favorably evaluated.

Even so, rather than employing a standard risk weight for these kinds of risks such as the New Accord uses, it would be preferable instead to stratify securitization tranches based on the asset classes, the originators, or the legal jurisdictions, and to then set precise risk weights for each category. From this viewpoint, there are problems about using such a high risk weight for low-rated tranches in markets such as the US RMBS market which are well recognized. In contrast, it is necessary to be more cautious about new types of securitization where there are still legal uncertainties, regardless of which tranche is being assessed.