REGIONAL BANKS ASSOCIATION OF JAPAN

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

COMMENTS ON THE CONSULTATIVE DOCUMENT
"THE NEW BASEL CAPITAL ACCORD"
OF THE BASEL COMMITTEE ON BANKING SUPERVISION

The Regional Banks Association of Japan is pleased to comment on the consultative document "The New Basel Capital Accord".

The followings are our comments on the consultative document. The comments were endorsed at our monthly board meeting held in 15th May after a wide range of discussion at each member banks and within the association as well, including dialogues with our supervisory authorities.

Yours sincerely,

Yukio Furushiro
General Manager, Planning Department

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OF THE BASEL COMMITTEE ON BANKING SUPERVISION

May 31, 2001
Regional Banks Association of Japan
Chairman, Sadaaki Hirasawa
(President of The Bank of Yokohama, Ltd.)

I. General Issues

It is our belief that the proposed "The New Basel Capital Accord" might have adverse or unexpected impact on each individual bank's own risk management activity and also the financial stability as a whole, unless Basel Committee's further considerations on developing the detailed design and future implementations of the new framework are appropriately undertaken. We believe the following three issues should be discussed within the committee's further deliberations.

(1)Harmonization with industry's own initiative to improve its risk management processes

Continuous sophistication of the regulatory capital framework should harmonize with, and provide positive incentives to each bank's own initiative to improve its risk management processes. Therefore it would be inappropriate, especially in the transitional period, to ask banks to:

i. perform excessively conservative and risk-sensitive estimation of risks (for example in the field of the benchmark risk weight, the recognition of credit risk mitigation and the eligible collateral etc.) ;
ii.establish excessively rigid internal management processes (various qualitative minimum requirement etc.) and
iii.make too much investment lacking in cost-profit analysis only for the purpose of implementing the new regulatory capital framework.

(2)Reduction of the potential adverse effects on economic cycles

We recognize that the more risk sensitive framework in the current proposal will make a bank's minimum regulatory capital requirement more volatile and potentially weaken the stability in the bank's management and its lending policy. To address this problem, we strongly insist that an appropriate modification to the calculation framework of the minimum capital requirements is needed to ensure that in reality the principle *"on average neither raises nor lowers regulatory capital for internationally active banks"*. In particular, in addition to the viewpoint (1)i. above, the consistent treatment for retail exposures should be ensured throughout the minimum capital requirements framework taking into account the lower risk profiles and the functions in national/regional economies.

(3)Appropriate Treatment for "banks of varying levels of complexity and sophistication"

To accomplish the goal that *"Although the new framework's focus is primarily on internationally active banks, its underlying principles are intended to be suitable for*

application to banks of varying levels of complexity and sophistication", the committee and each national supervisor should not hastily proceed with the work in a way which is only suitable for "internationally active banks". The risk profiles of "banks of varying levels of complexity and sophistication" and the functions of such banks in national economies should be incorporated more thoroughly within the work.

From this standpoint the following ***Individual Issues*** are prepared.

II. Individual Issues

1. The First Pillar: Minimum Capital Requirement

(1)Credit Risk – The Standardized Approach

To avoid such matters as overly conservative and risk-sensitive estimation of risks, establishing exceedingly rigid internal management processes and making too much investment that lacks in cost-profit analysis, we believe the following seven issues should be discussed.

a) Treatment for retail exposures

Currently, the rules for retail exposures are only addressed and set out in the field of the advanced IRB approach but not in the standardized approach, as the committee only states *"Depending on the outcome of work currently being undertaken in the field of the internal ratings based approach (IRB), the Committee will review the appropriate treatment for retail portfolios in the standardized approach"* (paragraph 40 in the supporting document). However, in light of the growing number of banks that consider retail banking more and more important, the treatment for retail exposures should be consistent throughout the minimum capital requirements framework; i.e. in general an appropriate treatment for retail exposures reflecting their risk profiles should be prepared both in the fields of the standardized approach and the foundation IRB approach.

b) The remaining risks for collateralized transactions

As a general rule, the credit risk mitigation of collateral is limited to 85% of the exposure as the threshold of the remaining risks (*"w=0.15"*) is set out in paragraphs 101 and 187. However, in light of the collateral management practices in normal market conditions, such a limitation would be too conservative to address the risks, but the "haircuts" adjustment should be sufficient. Taking into account the reliability and stability of collateral management practices in the industry, and continuous efforts to improve them, the remaining risks for collateralized transactions should be reduced to zero.

c) Internal use of the ratings of chosen ECAIs

For banks not being allowed to "cherry-pick" the assessments provided by different ECAIs, *"Banks must use the chosen ECAIs and their ratings consistently for each type of claim, for both risk weighting and risk management purposes"* (paragraph 49). This requirement is well understood in the regime of the IRB approach where it is intended to reflect a bank's own risk management practices to the regulatory capital requirements framework. However, if applied even in the standardized approach which is essentially a simplified "rule" to calculate regulatory minimum capital requirements, this requirement

could raise a concern that a bank would be discouraged from its own initiatives to develop more refined risk management processes. In order to prevent "cherry picking", the requirement above is not necessarily needed but consistent and conservative use of the ratings of chosen ECAIs over time should be ensured.

d) Bank claims with an original maturity of 6 months or less
Although it was permissible to apply preferential risk weight to claims with an original maturity of *"6 months or less"* subject to a floor of 20% in the 1999 first consultative paper, the scope has been reduced to *"3 months or less"* in this second proposal. Considering potential influences on the short-term inter-bank market, the former *"6 months or less"* period should be maintained.

e) Risk weight for unrated corporate claims
When a supervisory authority intends to increase the standard risk weight for unrated corporate claims under such situation as described in paragraph 36, it is desirable for the authority to take into consideration carefully the committee's intention not "*to cause an unwarranted increase in the cost of funding for small and medium-sized businesses, which in most countries are a primary source of job creation and of economic growth*" (paragraph 38 in the supporting document) .

f) Use of short-term assessment
The treatment set out in paragraph 56 (*"If the two claims are not pari passu, then the short-term claim should be treated as unrated"*) could be so extreme, particularly for the short-term claims on highly rated borrowers, that the claims should receive a risk weight based on that of long-term claims (for example, one category less favorable).

g) Securities issued by the collateral provider or by any related group entity
We contend that the treatment set out in paragraph 72 *("Securities issued by the collateral provider - or by any related group entity - would provide little protection and so would be ineligible")* is inconsistent with the treatment set out in paragraph 129 stating that *"corporates (including insurance companies) including parental guarantees rated A or better"* are included in eligible guarantors/protection providers. So the phrase in paragraph 72 referred to above should be deleted.

(2)Credit Risk – The Internal Rating-Based Approach

From the same point of view as the Standardized Approach, we believe the following four issues should be discussed.

a) Transitional arrangement between Standardized and IRB Approaches
If the transitional arrangement set out in paragraphs 159 and 161 *"A banking group using the IRB Approach must adopt the IRB Approach across (a) all exposure classes, (b) all significant business units and (c) all risk factors (i.e. PD, LGD, EAD etc.) within a reasonably short period of time"* is to be rigidly implemented from the start of the new accord, it raises a concern that banks will become discouraged from moving toward the IRB approach. As the transitional period for data requirements for three years are prepared (paragraph 163) and taking into account cost-profit consideration, the transitional arrangement should be flexibly implemented especially for within a certain

period of time from the start of the new accord.

b) Calibration of the benchmark risk weight
It is expected that currently proposed calibration of benchmark risk weight presented in paragraphs 175 and 176 will more or less raise risk assets in many banks, including our member banks, if the IRB approach is applied, and so this would not be in line with the committee's primary goal of the review that *"With regard to the level of overall capital, on average neither raises nor lowers regulatory capital for internationally active banks"*. In the committee's further considerations, the formula for derivation of risk weights should be modified to provide more incentives for moving toward the IRB approach, taking into account current field studies and consideration for economic cycles.

c) LGD adjustment for eligible CRE and RRE
We believe the treatment that eligible CRE and RRE meeting rigid minimum requirements only lowers LGD from 50% to 40% even when the ratio of collateral value to the nominal exposure exceeds a threshold level of 140% (paragraph 212) is too conservative. This should be modified so that the effect of credit risk mitigation by CRE and RRE will be recognized more positively.

d) Recognition of second charge over CRE and RRE
In the treatment set out in paragraph 320 *"no recognition for second charges will be provided"*, the second charges can well be recognized under the circumstances where the value of the collateral significantly exceeds the amount of the first charge. So in certain conditions, the committee should recognize the credit risk mitigation effect of the second charge.

(3)Operational Risk

Under the present situation in which there is no available reference data rich in both quality and quantity, we believe the following three issues should be discussed.

a) Time of implementation
With regard to the current discussion about operational risk, reference data underpinning the discussion seem poor both in quality and quantity, and furthermore the approaches and parameters proposed are considered tentative and unrefined.
For this reason, the committee should not be in haste to address the matter in order for it to be able to develop a reliable method which precisely reflects the level of operational risk management processes of a bank by taking into account current field studies throughout the industry. According to forthcoming discussions and the industry's preparation for the implementation, the committee should not necessarily regard the year 2004 as the fixed deadline.

b) Definitions of standardized business lines
It will be indispensable for the committee to receive sufficient data from the industry to set the parameters such as βs and γs appropriately, and it is also indispensable for banks to collect and accumulate meaningful data internally to prepare for the implementation.

To collect and provide the data smoothly, the use of several alternative definitions of standardized business lines (for example by regions, size etc.) reflecting the different nature of bank businesses and operations in many countries should also be approved. For regional banks with less diversified operations, more simplified or consolidated business lines are practical. For example, typically

- Retail and private banking
- Corporate banking
- Public institutions business
- Treasury and capital markets and
- Centralized activities

c) Setting of the "floor"

When applying the treatment set out in paragraph 559 (*"For banks applying the Internal Measurement Approach, the Committee will set a floor, below which the capital charge cannot fall"*), a bank's own initiative to improve its operational risk management processes (or to reduce the risk) would be rewarded with a limited reflection of the regulatory capital requirement of the bank and weaken the incentives for the initiative. Accordingly the requirement should be deleted.

2. The Second Pillar – Supervisory Review Process

Concerning the implementation of the Second Pillar, we believe the following two issues should be discussed.

(1)Supervisory authorities' involvement in banks' "economic capital"

We believe supervisory authorities' excessive involvement in banks' economic capital can raise a concern about a potential dilution of the significance of the regulatory minimum capital requirements and the situation where *"supervisors function as bank management"* (paragraph 36 in the supporting document). In light of this, we strongly support the principle set out in paragraph 626 "*Supervisors must take care to carry out their obligations in a highly transparent and accountable manner*" especially when "*a supervisor chooses to set target or trigger ratios or to set categories of capital in excess of the regulatory minimum*".

(2)Capital charge for the interest rate risk in the banking book

There can be cases where factors like the structure of the regional economy or relationship with local government finance in which a bank is incorporated makes it not always relevant to control "interest rate risk in the banking book" in a mechanical fashion subject to explicit risk limit. Therefore we believe the supervisory review for "*outlier banks*" should be applied in a prudent manner. Before taking a corrective action, supervisors should shape exact picture of the banks' interest rate risk through sufficient dialogue with them, clear understanding of the market/economic conditions they are incorporated and assuming several alternative conditions, such as the treatment for core deposits, when assessing the risk.