# Comments on “A New Capital Accord ” of Second Consultative Documents
# Issued by the Basel Committee on Banking Supervision

May 23, 2001
The Second Association of Regional Banks

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| **Overview** | 1. The Second Consultative Documents state “In connection with the standardized approach, the Committee desires neither to produce a net increase nor a net decrease – on average – in minimum regulatory capital, after accounting for operational risk.”<br><br>In this age of diversified banking operations and types of banks, banks having an overwhelming share of loans to small- and medium-size companies are likely to adopt the standardized approach and are less likely to see a decrease in the regulatory capital for credit risk by applying the standardized approach proposed by the Second Consultative Documents. On the other hand, if these banks are required to newly increase the regulatory capital for operational risk, the whole required capital may increase.<br><br>If such situation is anticipated, these banks may reduce the amount of credit available, | |

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| | which might have a negative impact on economic activity.<br><br>Therefore, the standardized approach should call for the following measures to be taken to reduce credit-risk assets.<br><br>Reducing the risk weight of the retail portfolio<br>Mitigating risk weight of credits by pledging real estate for commercial or residential use as collateral<br>Introducing adjustments by the granularity, which is being considered to be adopted in the IRB approach.<br><br>2. A major aim of the Second Consultative Documents is to make the Accord more risk sensitive.<br><br>On the other hand, the Financial Product Joint Working Group, which is discussing the global accounting standard, is considering the application of full market-value accounting to Financial Products and similar items.<br><br>In view of this, most balance-sheet items are likely to be subject to market-value accounting in the near future, and the minimum regulatory capital requirements | |

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| | unified by financial accounting.<br><br>Accordingly, in working out a new Basel Accord it is necessary to be aware of the possible revision of the accounting system and try to make accounting methods consistent with the capital adequacy requirement, from the viewpoint of double investments.<br><br>3. The international operations of the banks range from complex international transactions to routine transactions in a limited number of countries. Because of this difference in operational scope and consequently in the status of banks, supervisors should be prepared to allow banks a certain operational flexibility as they draw up a new Basel Accord. | |
| **Details**<br><br>**1. Standardized Approach**<br><br>(1) External credit assessment institutions (ECAI) (Rule Book, 45 and 46 | An ECAI must satisfy all of the following six eligibility criteria:<br><br>Objectivity, independence, international access, transparency, disclosure, resources and credibility<br><br>We should make sure that all these six criteria | It is uncertain how many existing ECAIs meet the six criteria. In addition, as the selection of agencies is up to the supervisor of each country, some may be more lenient than others.<br><br>When computing risk weight based on a credit rating, in order to maintain fairness we must prevent an ECAI from setting a discretionary |

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| | are met. | rating with a view to favoring national interests, or assigning a rating disadvantageous to other countries.<br><br>Although an ECAI might use an unsolicited rating to put pressure on entities to obtain an official rating, the Second Consultative Documents only state that “Such behavior, when identified, should cause supervisors to reconsider whether to continue recognizing such ECAIs as eligible for capital adequacy purpose.” The statement is considered inadequate. |
| **(2) Handling an approach to mitigating risk (Rule Book, 101, 102, 111, and 116)** | Though the remaining risk (W) involved in collateralized transactions is “0.15,” the remaining risk (W) involved in transactions collateralized by deposits should be “0” as in the exceptional case with government bond repos. | The risk weight in the simple approach is “0 %” and the remaining risk (W) in the on-balance sheet netting is “0” so handling not being consistent with there cases is not recommended. |
| **(3) Definition of retail in the standardized approach and adoption of granularity adjustments (Overview: 47)** | The definition of retail used in the standardized approach and whether to adopt granularity adjustments have not yet been decided. We request there should be no difference from the IRB approach. | A small bank using the standardized approach may try to avoid risks by limiting itself to transactions with individuals and other small-lot transactions. |

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| **(4) Credit-risk mitigation techniques Rule Book 76, 77, 78, and 79** | Neither the comprehensive approach or simple approach in the standardized approach cover risk mitigation by pledging collateral, including real estate for residential or commercial use (in certain circumstances, risk mitigation is allowed), so we request that the scope of collateral be expanded. | Real estate for residential or commercial use is eligible as collateral in the IRB approach, so banks adopting the standardized approach may suffer a competitive disadvantage. |
| **2. IRB approach**<br><br>**(1) Measuring benchmark risk weight for exposures to business corporations (Rule Book 174)** | In the Second Consultative Documents, the formula for calculating the benchmark risk weight is as follows, based on surveys and a model base:<br><br>BRW 976.5×N 1.118×G PD 1.288)× 0.470× PD $PD^{0.44}$<br><br>It remains to be determined whether it is appropriate to apply this formula internationally and whether the data on which this formula is based includes data from both times of US business boom and recession. In short, we request a clearer explanation of the basis of the formula. | In this formula, PD is set as 0.7 , LGD as 50 , and maturity as 100 in three years. In some banks' portfolios, the risk weight may be higher than that in the standardized approach.<br><br>This is inconsistent with the Committee's proposal that "the Committee hopes to see more banks moving from the standardized approach to the IRB approach." (Overview 37)" |

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| **3. Operational risk**<br><br>**(1) Indicator of basic indicator approach (Supporting Documents 22)** | In the basic indicator approach, "gross profits" is used as a Proxy of the amount exposed to operational risk. However, it is not appropriate to use the "gross profits," which are the earnings of the bank. We recommend that such indicators as the number of offices, customers (accounts) and staff be used, or considered. | There is no clear relation between an increase in the gross profits and an increase in operational risk. |
| **(2) Fixed -value percentage of basic indicator approach (Supporting Documents 23)** | In the basic indicator approach, the percentage is set as about 30% of the gross profits, even if it is a preliminary percentage. Though, at present, operational risk has not been defined clearly (according to the Second Consultative Documents, "the risk of direct or indirect loss resulting from inadequate or failed internal processes, people, and systems or from external events"), we consider 30% of gross profits is too large and that the percentage should be adjusted to reflect the situation in particular countries. | The frequency of the realization of operational risk at banks in Japan may be less than that at European and U.S. banks.<br><br>30% of gross profits is too large since the number of categories of business lines (Investment banks: 3 categories; Banks: 3 categories; Others: 2 categories) is small and the operational risk may be limited. |
| **(3) Basic indicator approach and standardized approach (Rule Book 552 and 553)** | There may be a difference in the frequency of the realization of operational risk in different countries. We should devise a procedure to evaluate risk objectively. | In the basic indicator approach, it is proposed that risks be measured by "gross profits" and in the standardized approach by the "gross profits" or the "annual average assets." There is accordingly a concern that the difference among banks will not be gauged with precision. |

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| **(4) Business lines Supporting Documents 26 and 33** | It is proposed that for business lines, the same approach (Investment banking: corporate finance, trading and sales; Banking: retail banking, commercial banking, and payments/settlements; Others: retail brokerage and asset management) is used for both the standardized approach and the internal measurement approach. We hope that a procedure reflecting each country's situation is adopted. | We understand that business lines vary from country to country. |
| **(5) Outsourcing Supporting Documents 48** | Concerning outsourcing in the Second Consultative Documents, reduction in the regulatory capital for operational risk is considered to some degree. However, we expect that a call for reducing the capital will be incorporated in the final draft. The Second Consultative Documents state "the bank conducting the outsourcing would need to demonstrate to the satisfaction of the supervisor that effective risk transfer has occurred" and "Banks should also develop appropriate policies and controls to assess the quality and stability of an outside service provider." We hope that unified criteria will be proposed. | We consider that outsourcing by banks will increase in the future in order to cut fixed costs, and cover the shortage of professional services and personnel/non-personnel resources. |

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| **(6) Handling insurance (Supporting Documents 50)** | The Second Consultative Documents are of the opinion that one way to mitigate operational risk is to take out insurance. We expect that various measures to mitigate risk will be incorporated in the final draft. | It is clear that taking out insurance mitigates risk. We think that the number of banks which will use or consider using insurance will increase. |
| **(7) Setting a "floor" (Supporting Documents 45, 46, and 47)** | We consider that no "floor" associated with the upgrade of the approach technique should be set. | If the required capital will decrease through an upgrading of the approach techniques, it means the standardized approach does not accurately reflect risk. For this reason, adjustments using a "floor" should not be made but the standardized approach should be improved. |
| **4. Supervisory review process (Second pillar)**<br><br>**(1) Setting trigger ratio and target ratio (Supporting Documents 58)** | The Second Consultative Documents state that supervisors "can set a trigger ratio, which is deemed to be the minimum capital required by the bank based on its risk profile. In addition, a target ratio may be established that would provide a warning that the bank is operating too close to the trigger ratio." However, we consider this ratio unnecessary because banks should conduct their operations at their own responsibility. | Banks take risks covered by their regulatory capital, so the setting of the a trigger ratio by supervisors would impose excessive restrictions on banks. |

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| **(2) Setting definitions of capital categories at a level higher than the minimum ratio (Supporting Documents 59** | The Second Consultative Documents state "Supervisors may choose to establish defined capital categories that apply to all banks" and "An example of such an approach would be one that uses a higher threshold of capital in order for a bank to be considered well capitalized as opposed to adequately capitalized." We request that these sentences be deleted. | The Rule Book 20 states "The ratio must be no lower than 8% for total capital. Tier 2 capital will continue to be limited to 100% of Tier 1 capital." Despite this, a move to set definitions of capital category by the supervisors at a level higher than minimum regulatory-capital requirements and its application to all banks will lead to abuse of regulations. |
| **(3) Interest-rate risk (Supporting Documents 7 and Overview 196)** | The outlier banks are defined based on interest-rate shock of 200 basis points, and risk mitigation and additional capital is required from such banks. These requirements should be introduced step by step, and therefore should not be obligatory but considered only as targets.<br><br>In the Second Consultative Documents, the interest-rate risk in the bank accounts is positioned to the second pillar from the previous first pillar, since such risk varies considerably in intrinsic risk and the process of monitoring such risk. We hope that the supervisors show in advance how they monitor such risk, and its objects/degree as well as any penalty. | |

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| **(4) Supervisory response (Supporting Documents 61)** | Seven items have been proposed as part of supervisory response, including tightening the monitoring of banks. We hope that the supervisors will reconsider the following items: “Requiring improvements in the controls environment in the bank, in terms of systems and/or personnel” and “Requiring that senior management and/or the board be replaced.” | The concerns on the left are involved in the internal systems of banks so it is considered that the authority of the supervisors extends too far. |
| **5. Market discipline (Third pillar)**<br><br>**(1) Items to be disclosed (Supporting Documents 41 and after)** | In the Second Consultative Documents, too many items are required to be disclosed. Some examples: “past record of average default probability by rating category and the definition of default,” and “past record of default probability for loans without rating” are required in “items recommended to be disclosed” of the standardized approach for the credit risk. Such disclosures seem unnecessary in the standardized approach so we request that the items to be disclosed be reduced. | Some banks which intend to adopt the standardized approach may not keep a record of the default probability at present. If additional disclosure is required, such banks may find it an excessive burden. Accordingly, we should more carefully select the items to be disclosed, considering cost-performance. |
| **(2) Principle of materiality (Rule Book 636 and Supporting Documents 20** | The Rule Book states that “whether disclosure is made is determined based on the principle of materiality.” On the other hand, the supporting documents state “The Committee does not intend to set out thresholds for disclosure.” | We consider that specific disclosure criteria are needed for banks to decide whether disclosure is necessary and to rationalize their operational workload. |

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| | We request that specific disclosure criteria be indicated. | |
| **(3) Frequency of disclosure (Supporting Documents 22 and 23)** | The Second Consultative Documents state that "It is desirable that the disclosures set out in this documents should be made on a semi-annual basis," "In certain categories of disclosure that are subject to rapid time decay, the Committee recommends quarterly disclosures," and "Where smaller banks make less frequent disclosures, the Committee believes it is important that they publish their justification for this." However, since it is excessively conservative to restrict the frequency of disclosure, we request the frequency be reconsidered. | We consider that disclosure should by its nature be at banks' own discretion. |
| **Matters on which the Basel Committee on Banking Supervision requires comments**<br><br>**Maturity Advanced techniques (Overview 109)** | "Experienced value or three years" is desirable rather than only three years. | If we calculated all exposures in the bank accounts, the average maturity of many banks will be three years or less (arithmetic average). |

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| **Method of calculating risk weight (Overview 122)** | For portfolio covering retail, PD/LGD (EL) by segment is required to be computed but it is not necessary to subdivide the segments for each type of financial product. Accordingly, the following three categories are desirable.<br><br>For business purpose, For purposes other than business (the purpose of funds is defined, the purpose not defined) | The credit risk is affected by who the obligor is, rather than the purpose of funds. Accordingly, if the conditions of collateral and guarantee are the same, it is considered there is no difference between risks by product so it is better to simplify the category. |
| **Drawing up more appropriate methods for specifying loss types (Operational risk) (Supporting Documents 8)** | Risks common to each country should be standardized and other risks should be at the discretion of the supervisors of the country. | Risks common to each country should be standardized and other risks should be at the discretion of the supervisors of the country. |