Comments on the second consultative document:

“The New Basel Capital Accord”

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Table of contents

Comments on the second consultative document: “The New Basel Capital Accord”

1. Reasons for commenting on the second consultative document: “The New Basel Capital Accord”

These comments on the second consultative document: “The New Basel Capital Accord” issued by the Basel Committee on Banking Supervision in January 2001 aim at contributing to the discussion on the review of the Capital Accord. The revised Capital Accord will have a significant impact on bank management, and these comments are intended to ensure it is in line with the appropriate development of management of private-sector banks as well as risk management.

2. Principal policies for commenting

(1) Make requests to achieve the objective of the review of the Capital Accord: “to align capital adequacy assessment more closely with the key elements of banking risks and to provide incentives for banks to enhance their risk measurement and management capabilities (Paragraph 2 of the Executive Summary)”
(2) Make requests to ensure a level playing field in the review process for the Capital Accord (Paragraph 14 of the first Consultative Document issued in June 1999)”

3. Major comments

I. Credit risk

i. Shape of the risk-weight function

[Rulebook (*): Paragraphs 171 – 177]

(The shape of the benchmark risk-weight function under the Internal Ratings-Based Approach is determined in these paragraphs.)

(*) In this document, "Rulebook" refers to "The New Basel Capital Accord", i.e. the main part of the Consultative Document.

Request

When PD is over 0.7%, the proposed benchmark risk-weight function gives a risk weight that increases beyond 100%. Considering the importance of the risk weight in this range, the total risk asset may not be reduced from the level under the current Capital Accord. This might be disincentive to moving to the Internal Ratings-Based Approach. We therefore request that the shape of the curve be modified.

The formula for the benchmark risk-weight function contains two adjustment factors: "PD Measurement Error" and "Tier 2 adjustment". The uniform multiplication factors of 1.2 and 1.3, respectively, make the risk-weight curve steeper. These two numbers are extremely conservative and do not seem to be theoretically well-founded. We accordingly request that these multiplication factors be removed.

ii. Recognition of only the first claim as real estate collateral

[Rulebook: Paragraph 320]

Under this approach, no recognition for second or subsequent charges will be provided, and these will be treated as senior unsecured exposures.

Request

Recognition for second or subsequent charges should be provided for. We make the following counter-proposal.

(Counter-proposal)

C: Value of collateral after haircut (market value multiplied by a certain factor)
C_1: Total amount of the senior claim
C_2: Amount of subordinate claim
C_{2ph}: Value of collateral to be recognized when the amount of subordinate claim is C_2

(1) When $C > C_1 + C_2$, $C_{2ph} = C_2$
(2) When $C < C_1 + C_2$, $C_{2ph} = \mathrm{Max}\,(0, C - C_1)$

(Reasons)

In many instances, the value of collateral greatly exceeds the amount of the first claim and therefore sufficiently covers the second or subsequent charges. It is accordingly not appropriate to recognize only the first claim.

We are also concerned about the possibility that the incentive for taking collateral might be diminished as second or subsequent charges with sufficient market value would not be recognized for regulatory capital purposes.

iii. Risk mitigation effect of physical collateral

[Rulebook: Paragraphs 209 – 212]

Recognition of commercial and residential real estate collateral

Request

More recognition should be given to the risk mitigation effect of real estate collateral.

(Reasons)

It is highly likely that LGD is below 40% if the value of real estate collateral exceeds the exposure amount at default. We therefore think that the ratio of LGD reduction due to the increase in collateral value vis-à-vis exposure should be treated in broadly the same manner as for eligible financial collateral. This is particularly the case, as for defaulted assets collection through sale of the collateral real estate will be carried out expeditiously. Therefore, the actual LGD is not as high as 40% if the collateral value exceeds the exposure amount.

The volatility arising from fluctuation of the market value of the collateral real estate can be incorporated by way of adjustment using haircut rates, as in the case with eligible financial collateral.

Given that the new Approach aims at being risk-sensitive, when collateral is taken, its risk mitigation effect should be recognized correspondingly across the board. We request therefore that the proposed threshold level of 30% for recognition of such an effect be reduced to zero.

iv. Definition of retail exposures [1]

[Rulebook: Paragraph 156]

Lending to small businesses in relation to the definition of retail exposures.

Request

We think that lending to small businesses in relation to the definition of retail exposures should be determined by supervisors based on the respective national laws and regulations.

(Reasons)

One approach would be to define lending to small businesses based on the attributes of companies such as asset size. It is, however, not appropriate to establish a single standard globally as the size and structure of economy is different from country to country.

Accordingly, it would be more desirable to make use of the criteria established by each national law and regulation.

v. Definition of retail exposures [2]

[Rulebook: Paragraph 156]

Product Criteria: the exposure takes the form of any of the following: credit cards, instalment loans (e.g. personal finance, leasing), revolving credits (e.g. overdrafts), residential mortgages, and small business facilities.

Request

We make the following counter-proposal.

(Counter-proposal)

Product Criteria: National supervisors may establish product criteria. Examples include the following products: credit cards, instalment loans (e.g. personal finance, leasing), revolving credits (e.g. overdrafts), residential mortgages, and small business facilities.

(Reasons)

Retail products offered by banks vary from country to country in many cases due to the difference in commercial practice etc. For example, it is determined by practice whether a personal loan is made on credit card or deed, not by the difference in risk characteristics between them. It is therefore difficult to globally apply a uniform rule that explicitly specifies products concerned. National supervisors who are familiar with the actual situation in the respective countries should be able to establish the criteria as in the case with “Low-value of individual exposures” and “Large number of exposures” referred to in the same paragraph.

vi. Criteria for retail portfolio

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 350]

The Committee seeks particular comment on the interaction between the criteria articulated in the proposed definition and banks’ own internal definitions of retail portfolios, particularly with respect to the treatment of small business lending.

Request

We would like to confirm that paragraph 156 of the Rulebook: “the bank treats such exposures in its internal risk management and risk assessment processes consistently over time in the same way as other retail exposures” does not require banks to apply “other rating systems than for corporate exposures” to retail exposures. Risk assessment processes for individual transactions depend on the organization and operation of the bank. To apply the rating system for corporate exposures to retail would prevent the possibility of confusion arising from multidimensional processes as well as deterioration of precision. In light of regulatory capital, it would be sufficient to explicitly determine specific PD, LGD etc. for the retail segment and perform internal risk management consistently (cost charge, capital allocation).

vii. Segmentation for retail exposures

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 353]

Feedback on the proposed minimum requirements for retail exposures is welcome, particularly in respect to (a) the proposals for segmentation, (b) further development of the requirements for estimation of EAD, and either PD/LGD or EL, including estimation using the reference definitions of default and loss, and (c) the requirements for internal validation.

Request

As for (a) segmentation, we think that (i) segmentation by product type is essential. However, (ii) segmentation by borrower risk should not necessarily be required depending on the product type.

(Reasons)

As criteria for (a) segmentation, both (i) product type and (ii) borrower risk are required. It depends, however, on the nature of the product concerned whether (ii) borrower risk needs to be considered. In the case of revolving credits and card loan, for example, it has a significant implication to segment “borrower risk” by delinquency rate etc. since this also has an impact in relation to practical control such as reviews of credit limits. For mortgage loans, however, “borrower risk” is limited to the range above a certain level at the outset because of the sales criteria. EL depends largely on the fluctuation of the “value of the real estate collateral” after the deal execution, and the change in “borrower risk” is small or difficult to capture. In such cases, segmentation by “borrower risk” would not be important from a practical control point of view.

Making segmentation by borrower risk essential would lead to a management focusing on PD, which is not consistent with the risk concept for retail exposures based on EL.

viii. Requirements for the advanced IRB Approach

[Rulebook: Paragraphs 342, 379]

Estimates of LGD (par. 342) and EAD (par. 379) must be based on a minimum data observation period that must in any case be no shorter than a period of seven years.

Request

It is not necessary to set the minimum data observation period at seven years. It should be the same as for estimates of PD, i.e. five years.

(Reasons)

There is no rational reason for setting the minimum data observation period for estimates of LGD and EAD at seven years as compared to five years for estimates of PD. With an observation period of five years, it would be possible to incorporate economic cycles conservatively into the LGD/EAD estimates to the same extent as for PD. The appropriateness of the estimation can be verified under Pillar 2.

ix. Reference definition of default

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 256]

The Committee seeks comment on the proposed reference definition of default, and on the applicability of this definition to banks' historical data.

Request

We request that each item for reference definition be more clearly stated.

The second Consultative Document stipulates that the reference definition of default includes the following.

(1) The obligor is unlikely to pay its debt obligations.
(2) The obligation is subject to charge-off and specific provision.
(3) Forgiveness or postponement of principal, interest or fees
(4) The obligor is past due more than 90 days.
(5) Legal bankruptcy

- Problems on inclusion of "(3) Forgiveness or postponement of principal, interest or fees; (4) The obligor is past due more than 90 days."

Under the advanced Internal Ratings-Based Approach, banks may internally estimate LGD and that will be based on the reference definition of default referred to above.

Among the instances of (3) and (4) which have not reached the stage of (2) or (5), there are cases in which loss cannot be fixed even after general provision is temporarily made, and the obligation may finally revert to performing status due to interest rate raise associated with the improvement of the business performance of the obligor. In this case, LGD can be regarded as zero. On the other hand, when (3) or (4) reaches the stage of (2) or (5), or the obligor reaches (2) or (5) directly, the loss will be fixed and a certain LGD will be experienced accordingly. If obligations in categories (3) and (4) should be defined as "default" in the same context as for bankruptcy, it would be necessary to specify one LGD covering a very wide range of recovery rates. This could make the framework unstable. Estimates of LGD and LGD mitigation effect of collateral might vary depending on the interpretation and the sampling method employed. Therefore, the approach should be more clearly described.

- Problems on "(2) The obligation is subject to charge-off and specific provision."

The system for charge-off and provisioning is different from country to country. This reference definition, therefore, might not be fair due to the unequal criteria among jurisdictions. In case where the system for charge-off and provisioning is amended, it would be necessary to determine its treatment for regulatory capital purposes.

x. Treatment of defaulted assets [1]

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 188]

Another related issue is the assessment of IRB capital against defaulted loans. One possible treatment is to measure exposures as loans net of charge-offs and specific provisions and to apply the IRB risk weight which is not affected by charge-offs and specific provisions. In this case, however, for each dollar of charge-off taken, the bank's total capital (numerator of the capital ratio) declines dollar for dollar, but IRB capital requirements for that loan decline only by a significantly lesser amount. This creates incentives for banks not to charge-off loans in a timely fashion. The Committee invites comment on this issue.

Request

We are opposed to the treatment to measure exposures as loans net of charge-offs and specific provisions. In order to give banks incentives for timely charge-off of loans, the effect of charge-off and specific provisions should be taken into account as much as possible. The appropriate method is to deduct the amount of charge-off and specific provisions directly from the required capital amount calculated for the exposure before charge-off and specific provisions under the Internal Ratings-Based Approach.

xi. Treatment of defaulted assets [2]

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 258]

The Committee would welcome comments on the internal relationship between non-performing loan categories and the definition of default. In this context, the Committee also seeks comment on the treatment of non-performing loans within banks' internal capital allocation systems. One issue of special interest would be the treatment of EAD for on-balance-sheet assets with regard to partially provisioned loans.

Request

As for defaulted obligors, banks in Japan are permitted by the practice for charge-off / provisioning to make a direct deduction from both sides of the balance sheet after making specific provisions for the exposure not covered by collateral. If it should be accepted to deduct the amount of specific provisions from the required capital amount as mentioned above in relation to Paragraph 188 on the "treatment of defaulted assets", the calculation of required capital should be made on the exposure amount before such a specific provisioning, i.e. the amount with the direct deduction added-back. Otherwise, the required capital amount would increase when the direct deduction is made, which is not reasonable. Direct deduction is an important treatment to remove non-performing loans from the balance sheets of banks. The regulatory capital framework should not become an impediment to it.

xii. Calibration of corporate risk weight

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 259]

The proposed risk weights are based on calibration to assessments of EL plus UL. The effect of setting weights in this manner will vary depending on national definitions of provisions and loan loss reserves and on the extent to which banks have general provisions that are greater or less than the limit of 1.25% of risk weighted assets that applies to the inclusion of general provisions in supervisory capital. The Committee welcomes comment on this specific issue as well as on the broader issue of how to ensure adequate coverage of both EL and UL within the context of regulatory definitions.

Request

When the calibration is based only on UL, it may be possible to deduct from the capital i.e. the numerator, the general provisions which are included therein under the current Capital Accord. Profit reserve and general provision, however, constitute the same profit account in relation to capital in terms of financial accounting. To deduct only general provisions from capital might lead to unfair treatment among countries depending on the national system for provisioning.

We think therefore that calibration based on EL + UL, which is the basis for calculation of the capital adequacy ratio under the current Capital Accord, would be more appropriate. If the calibration should be based only on UL, it should be allowed to include general provisions in the capital as mentioned above.

xiii. Treatment of equity exposures

[Supporting Document on the Internal Ratings-Based Approach: Paragraphs 381 - 395]

Major issues related to establishment of an approach to equity exposures for the banks employing the Internal Ratings- Based Approach.

Request

The treatment of equity differs widely from country to country depending on history, regulations etc. It is therefore not appropriate to establish one uniform rule on all the equity exposures for regulatory capital purposes. They should be treated differently according to the purpose of the holding. “A methodology based on market risk or stress testing” is appropriate for equities held for trading purposes, start-up and venture capital positions, indirect positions through funds and equity held as a result of debt / equity swaps. For equities with other holding structures, such as equities held by request of the clients or in order to maintain / develop the relationship with the clients in connection with banking business (loan / deposit, foreign exchange etc.), a PD / LGD based approach would be appropriate. By regarding equity as a “loan” with the longest maturity having an LGD of 100% in a “PD / LGD based approach”, all the corporate exposures can be treated in the same framework.

II. Operational risk

i. Structure of the Internal Measurement Approach

[Rulebook: Paragraph 556] Internal Measurement Approach Capital charge for each business line / risk type combination is the product of γ and EL. [Supporting Document on Operational Risk: Paragraph 32] Internal Measurement Approach The overall capital charge for a particular bank is expressed as; Required capital = γ * EI * PE * LGE

Request

As for the Internal Measurement Approach, we propose the following with a view to making it a risk-sensitive method that reflects in regulatory capital the difference in risk profile of each bank as well as risk mitigation measures.

(1) To make γ * PE a non-linear function (hereinafter f(PE)) by analogy with the Internal Ratings-Based Approach for credit risk.
(2) To introduce Risk Profile Index (hereinafter RPI) to reflect the low-frequency / high-severity situation characteristic of operational risk.

We propose the explicit formula for the IMA as described in Appendix A.

[Excerpt from Appendix A]

$$\text{Required capital} = \text{EI} \times f(\text{PE}) \times \text{LGE} \times \text{RPI}$$
$$= \text{EI} \times f(\text{PE}) \times \text{LGE} \times (1 + \text{RPI}_1 \times \text{RPI}_2)$$

RPI_1 Adjustment factor for severity, RPI_2 Adjustment factor for frequency

$$= \text{EI} \times f(\text{PE}) \times \text{LGE} \times \left(1 + \frac{10\sigma}{\mu} \times \frac{1}{\sqrt{n}}\right)$$

f(PE) = λ x N(1.118*G(PE)+1.545)
n : the number of event
μ : Mean of the transaction amounts constituting EI
σ : Standard deviation of the transaction amounts constituting EI
λ : Determined for each event type
: 0.014 [Processing Risk]; 0.029 [Systems Risk]

(Explanation)

A formula for the operational risk UL corresponding to the loss distribution cannot be obtained by simply multiplying EL by γ. As in the case with the IRB Approach for credit risk, a non-linear function for PE should be introduced. Furthermore, a formula better corresponding to the actual loss distribution can be obtained by introducing an adjustment factor RPI which reflects the "low-frequency / high-severity situation" characteristics of operational risk. With the introduction of such factors, the Internal Measurement Approach

can become a more risk-sensitive method that reflects on regulatory capital the difference in risk profile of each bank as well as risk mitigation measures.

- For details of the requests / reasons, please refer to Appendix A.

ii. Exposure Indicator

[Supporting Document on Operational Risk: Paragraph 34] The exposure indicator (EI) represents a proxy for the size of a particular business line's operational risk exposure.

Request

We request that the Exposure Indicator for the Internal Measurement Approach be risk sensitive. As demonstrated in Appendix B, the EI appropriate for operational risk in trading & sales, retail banking and commercial banking should be the transaction amount.

(Reasons)

What corresponds to EI in the credit risk context is EAD. Normally, EAD is defined as the outstanding balance of loans, not gross income. There may be some relationship between loan balance and gross income, but the degree of such linkage is different from bank to bank. What is exposed to credit risk directly is the loan balance. Similarly, for operational risk, EI must be an item that is exposed to operational risk, not a simple scaling factor.
Furthermore, EI must contain the information to determine the RPI characteristic of operational risk.
If EI is defined as the transaction amount, the above requirements will be met. Such a definition can be made common across banks and countries. Furthermore, collection of the relevant data is possible.
If EI is not defined correctly, the wrong incentives might be given to banks in terms of operational risk management. Especially, asset size is not suitable for EI. Asset size as EI would turn the capital charge on operational risk back to a system similar to the current Capital Accord for credit risk. This is the reason why a definition of EI appropriate for operational risk is essential.

- For details of the requests / reasons, please refer to Appendix B.

III. Asset securitisation

Treatment of liquidity facilities under asset backed securities (CP) programme

[Rulebook: Paragraph 534]

In general, liquidity facilities provided by sponsors or repackagers may be treated as commitments for risk-based capital purposes provided that such facilities do not support credit losses. In order to ensure that the facility is used purely for liquidity purposes, the following requirements should be met.

[Rulebook: Paragraph 535]

Facilities that are determined to be primarily liquidity enhancements may be converted at 20% and generally risk-weighted at 100%.

Request

The test of "liquidity enhancement" referred to herein should be applied only to securitisation transactions etc. of "asset pool" type. As for asset securitisation transactions of "specific negotiation" type which are predominant in Japan, test criteria for commitments for corporates with an original maturity up to one year for risk-based capital purposes referred to in paragraph 43 of the Rulebook should be determined separately in accordance with their characteristics

The risk weight for liquidity facilities should not be set uniformly at 100%. Risk weights according to the creditworthiness of the underlying assets should be applied by way of look-through approach.

(Reasons)

(1) Securitisation transactions are entered into on an uncommitted basis according to the normal credit control procedure of the bank. There has been no instance at our bank where the back-up line has been drawn down.
(2) In Japan, asset securitisation is still at the development stage. Furthermore, due to the commercial practice etc., specific negotiation type is expected to remain predominant.
(3) Specific negotiation type does not involve a structure that distinguishes between senior and subordinate claims. Credit is controlled in the same manner as for the obligor concerned.
(4) Applying a risk weight of 100% uniformly would mean that the risk profile would be ignored.

4. Other comments

I. Credit risk

i. Treatment of collateral

[1] Treatment of deposit collateral

[Rulebook; Paragraphs 88, 101] Treatment of collateral under the comprehensive approach
[Rulebook; Paragraph 111] Treatment of collateral under the simple approach
[Rulebook; Paragraph 116] On-balance sheet netting

Request

We request that the risk weight for transactions collateralised with deposit be set at 0% under the comprehensive approach.

(Reasons)

The risk weight for transactions collateralised with deposit is 0% under the simple approach if they are denominated in the same currency (paragraph 111). It is also 0% when on-balance sheet netting is permitted. Under the comprehensive approach, the haircut for transactions collateralised with deposit is 0%. In calculating risk weight, however, the remaining risk of 15% must remain (paragraph 101). The comprehensive approach should be alleviated of such a disadvantage.

[2] Distinct unit for collateral management

[Rulebook: Paragraph 321]

Collateral management should be contained within a distinct operational unit of the bank.

Request

We request that this paragraph be changed to the following.

"Collateral management should be either contained within a distinct operational unit of the bank or performed subject to verification of the appropriateness of the management functions such as existence of a checking mechanism by such a unit and an adequate audit system."

(Reasons)

It is not necessary that a distinct operational unit perform collateral management.

ii. Minimum requirements for rating systems

[1] Update of ratings

[Rulebook: Paragraph 247]

Once (the information is) received, the bank needs to have a procedure to update the borrower's risk rating in a timely fashion, in general, within 90 days. Borrowers whose financial condition is weak or deteriorating should receive priority and be updated generally within 30 days of receipt of this information.

Request

We request that this paragraph be removed.

(Reasons)

In reviewing ratings, financial institutions give priority to the obligors whose creditworthiness is questioned. Update of ratings, however, may not always be completed within 90 days (30 days for borrowers whose financial condition is weak or deteriorating) of receipt of the relevant information because accounting closing generally tends to concentrate heavily in particular months in each country. It would not be appropriate for regulation to stipulate the actual schedule for rating updates.

[2] Reporting of rating information

[Rulebook: Paragraph 249]

Reporting should be on a monthly basis, and should include risk profile by grade, migration across grades, quantification of loss estimates per grade, and comparison of realised default rates against expectations.

Request

We request that the requirement for reporting frequency in this paragraph be removed.

(Reasons)

Deterioration of creditworthiness is caused by external factors such as stability of economy, asset structure of portfolio etc. The reporting frequency, therefore, should be determined at the discretion of each financial institution. It is not suitable for regulation.

[3] Consideration of all relevant information

[Rulebook: Paragraph 265]

Banks should take all relevant information into account in assigning ratings to a borrower.

Request

We request that this paragraph be changed to the following.

"Banks should take the relevant information deemed to be necessary into account -----"

(Reasons)

The types of information used in rating assignment are determined by each bank after fully checking its importance and efficiency. Therefore, it is not appropriate to require banks to consider “all relevant information”. The paragraph should stipulate that the information banks deem to be necessary be taken into account.

[4] Information for estimating the average PD

[Rulebook: Paragraph 274]

Banks should consider all available information for estimating the average PD per grade, including the three specific techniques set out below (internal default experience, mapping to external data, and statistical default models).

Request

We request that this paragraph be changed to the following.

“Banks should consider as wide a range of information as possible when estimating the average PD per grade.”

(Reasons)

Methods for estimating the average PD should be selected by each bank at its own discretion considering also the cost performance. It is not appropriate for the regulation to set out all the alternatives.

As for the three specific techniques provided, when internal default experience is employed for the estimation, the other two techniques would be considered only for introduction or review of a rating system, not for estimating the average PD. If more than one model is employed, the different results might be used arbitrarily, which would not be appropriate. In light of cost performance, such an approach is not desirable because it would increase the burden for financial institutions.

[5] Storing data on rating

[Rulebook: Paragraph 287]

Banks must collect and store data on key borrower characteristics and facility information, as well as the rating and default histories. These data should be sufficiently detailed to allow retrospective re-allocation of obligors to grades.

Request

We request that this paragraph be removed.

(Reasons)

It would be a significant burden and therefore difficult to construct a database on obligors that enables retrospective re-allocation of grades. Accordingly, it should not be described as a minimum requirement. When retrospective re-allocation is not feasible, other approaches, such as allowing substitution of PD, should be taken.

iii. Maturity

[1] Method for maturity adjustments

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 127]

With respect to the advanced IRB approach, any bank employing the advanced approach for LGD, EAD, or guarantees/credit derivatives would be required to explicitly incorporate maturity effects on risk weights. As such, a credit's risk weight would depend on its PD, LGD, and "effective maturity", which emphasises the contractual rather than economic maturity of exposures. The Committee is seeking specific comment on the approach for calibrating the maturity adjustments using this concept of effective maturity.

Request

Under the mark-to-market paradigm (MTM mode), sensitivity to maturity declines as the PD increases. It would be more desirable to maintain this sensitivity to a certain extent even if the PD rises. This would provide an incentive for reducing maturity for high PD borrowers when maturity is considered, which would be more appropriate in light of risk management.

iv. Mapping technique for inconsistent definition of default

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 257]

Conceivably, it may be possible to develop a technique through which PDs derived by a bank using definitions of default which were not consistent with the reference definition could be mapped to the reference definition. Industry is invited to provide feedback on the feasibility of such an approach, and on the data required to calibrate it.

Request

It is an effective way of avoiding the disadvantage of double control to map the PDs derived from the definition of default for banks' internal control purposes to the reference definition of default.

If such a technique should be determined uniformly by regulators, it is questionable whether the following requirements can be met: (1) Consideration of various factors such as asset structure of each financial institution; (2) Determination of the relationship between the PDs based on the reference definition and the internal definition, which should be stable and not unreasonably unfavourable to any particular banks. Even if the relationship is estimated based on banks' internal data, it would be required to collect the data for the past several years anew, which has not been relevant to their own internal control. We are concerned that such a burden could be enormous.

In cases where the definition of default is different, it should also be discussed how to treat the estimates of LGD, which would make the estimation difficult.

v. Advanced IRB Approach

[Rulebook: Paragraph 343]

If a positive correlation can reasonably be expected between the frequency of observed defaults and the severity of LGD, the estimate should be adjusted with a conservative bias.

Request

As to this paragraph, we request that the following points be clarified.

(1) Range of applicable portfolios; (2) Method for measuring the correlation; (3) Method for adjusting the correlation.

(Reasons)

Presumably, this paragraph implies that the relationship between the frequency of observed defaults and the severity of LGD should always be examined. Depending on portfolios, however, it would be sufficient to estimate PD and LGD conservatively. It is therefore necessary to clarify what types of portfolios are subject to the above treatment. The method for measuring the correlation, which is not clarified in this paragraph, should be described from a practical viewpoint.

vi. Retail exposures

[1] Treatment of high-PD retail products

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 313]

As a consequence, the illustrative risk weights for retail portfolios may overstate appropriate minimum total capital levels for higher-PD retail products, such as credit cards. The Committee welcomes comment on this specific issue as well as on the broader issue of how to ensure adequate coverage of both EL and UL within the context of regulatory definition of capital.

Opinion

It is reasonable that the risk weight for retail portfolios is half of that for corporate exposures because of the diversification effect etc. despite the fact that it has higher PDs than for corporate. Accordingly, we have no problem with the proposed formula.

[2] Risk weight formula by product

[Supporting Document on the Internal Ratings-Based Approach: Paragraph 352]

--- while the current proposals provide for a single risk weight function across all retail products, the Committee is also considering whether different risk weight formulae are warranted for different product types. Feedback on these issues is particularly welcome.

Request

Measurement of risk by product is already incorporated in the estimation of PD. It is therefore not necessary to modify the risk weight formula depending on product. Such a modification would rather complicate the internal control unnecessarily.

II. Asset securitisation

[Rulebook: Paragraph 518]

In order for an originating bank to remove securitised assets from its balance sheet for purposes of calculating risk-based capital, the bank must transfer the assets legally or economically via a true sale, e.g. novation, assignment, declaration of trust, or subparticipation. More specifically, a clean break has occurred only if:

(a) the transferred assets have been legally isolated from the transferor; that is, the assets are put beyond the reach of the transferor and its creditors, even in bankruptcy or receivership. This must be supported by a legal opinion.

Request

The main text regards true sale as legal or economic transfer of assets and refers to subparticipation as an example. On the other hand, sub-text (a) defines true sale as legal isolation of the transferred assets from the transferor. The relation between these two definitions is not clear.

It should be clearly stated that sub-texts (a), (b) and (c) describe the requirements for "legal" transfer of assets referred to in the main text, using examples. In other words, "More specifically, a clean break ---" should be replace with "Among these, clean break that constitutes legal transfer of assets includes ---."

Alternatively, (a) should be changed to: "the transferred assets have been legally isolated from the transferor (or isolated with the same or larger economic effect) ---."

(Reasons)

Under loan participation in Japan, which is similar to subparticipation, the underlying assets are not legally transferred. However, it provides the same economic effect as transfer of the assets through negotiation of "profit participation" which represents the economic return and risk of the underlying assets. Its off-balance sheet effect is recognised under the Japanese accounting standard.

[Rulebook: Paragraph 520]

In general, originators and loan servicers that provide credit enhancement must deduct the full amount of the enhancement from the capital, taking into account the risk-based capital charge that would have been assessed if the assets were held on the balance sheet.

[Rulebook: Paragraph 532]

First loss credit enhancement provided by a sponsor must be deducted from capital.

[Rulebook: Paragraph 539]

For banks issuing securitisation tranches, the full amount of retained first-loss positions would be deducted from capital, regardless of the IRB capital requirement that would otherwise be assessed against the underlying pool of securitised assets.

Request

As for capital charge on credit enhancement, it would not be appropriate to deduct its full amount from the capital (numerator). It should be included in the risk asset (denominator) in consideration of diversification effect (granularity) with a cap amount set at the aggregate of the risk assets of individual underlying assets related to the credit enhancement.

(Reasons)

(1) Fully deducting the credit enhancement from capital does not take into account the risk profile of the underlying assets and implies that the possibility of losing the entire amount is extremely high. This argument is not theoretically well-founded.
(2) Fully deducting the credit enhancement from capital might lead to a risk weight higher than that for the underlying individual assets. This is not economically rational.
(3) As for calculation of risk assets of credit portfolio of banks, the regulation tends towards recognition of diversification effect (granularity). Pool of securitised assets that is diversified to a certain degree should be treated in the same manner.

[Rulebook: Paragraph 524]

This section sets out the treatment of investments in ABS made by third parties.

(Paragraphs 524 – 530 of the Rulebook refer to investments in ABS.)

Question

There is a transaction scheme similar to ABCP in which the bank purchases financial assets of its clients by extending a loan with limited recourse to an SPC. We would like to confirm that the risk weight in this case can be calculated based on the bank's internal ratings for individual obligors via look-through approach.

(Reasons)

[Rulebook: Paragraph 526; Supporting Document on Asset Securitisation: Paragraph 27]

Securitisation tranches are risk-weighted as follows.

External Credit Assessment	Tranches
AAA to AA-	20%
A+ to A-	50%
BBB+ to BBB-	100%
BB+ to BB-	150%
B+ and below or unrated	Deduction from capital

Request

Risk weight for securitisation tranches should be the same as for corporate exposures.

(Reasons)

Credit risk of securitised assets is diversified (especially in the case of asset pools etc.). The rating is therefore comparatively stable as the UL of the securitised assets is smaller than the aggregate of the ULs for the underlying assets. As long as risk weight is based on the evaluation of EL + UL, securitised assets should be given risk weights that are lighter than for corporate exposures, or the same as for corporates but subject to adjustment for granularity.

[Rulebook: Paragraph 527; Supporting Document on Asset Securitisation: Paragraph 29]

--- senior ABS, which are part of a securitisation structure that is not rated, may be accorded a look-through treatment, i.e. be assigned to the risk category appropriate to the underlying assets.

(Rulebook: Paragraph 529; Supporting Document on Asset Securitisation: Paragraph 31)

An underlying pool of an ABS that qualifies for the look-through approach may be composed of assets that are assigned to different risk weight categories. <u>In such a situation, the unrated senior ABS are assigned a risk weighting according to the highest risk-weighted asset that is included in the underlying asset pool.</u>

Request

The underlined part should be amended so that the risk profile of the entire pool of underlying assets can be reflected on the risk weight. An example of method would be;

"Calculate the 'weighted average PD' based on the PDs corresponding to the ratings for individual underlying assets in the pool. Assign a risk weight based on the rating corresponding to such a PD."

(Reasons)

The notion of "the highest risk-weighted asset that is included in the underlying asset pool" would ignore the risk profile of the pool. For example, if only one in a pool of 100 companies is downgraded or defaults and the risk weight for this company becomes higher than that for other 99, the risk weight for the entire pool would also increase by the same factor. This is an overestimation of risk.

[Rulebook: Paragraphs 543 - 544]

Even when a securitisation transaction meets the clean break criteria as specified in paragraph 519, originators may be subject to "moral" or reputational risk. As a result, the institution may choose to provide support that exceeds its contractual obligations (i.e. implicit recourse) to a securitised pool of assets.

The following measures will apply when an institution is determined to have provided implicit recourse:

(i) If it is determined that an institution has provided implicit recourse to any portion or tranche of a securitisation that it has originated, then all of the assets associated with this structure (i.e. not only a particular tranche but all tranches) will be treated as if they were on the bank's balance sheet.

(ii) If a supervisor determines that an institution has provided implicit recourse on a second and subsequent occasion, then all of this institution's securitised assets – not just the structure for which implicit support was provided – will be treated as if they were on its balance sheet and risk-weighted accordingly. In addition, the bank will be prevented from gaining capital relief through the securitisation process for a period to be determined by the bank's supervisor.

(iii) In both instances, banks will disclose publicly that they were found to have provided implicit recourse and the consequences of such actions as outlined above. This disclosure will include the impact of the securitised assets reverting back to the bank's balance sheet and the potential for further supervisory action, as appropriate.

Request

There might be a case where an institution provides support that exceeds its contractual obligations to a securitised pool of assets in order to respond to a change in circumstances etc. after the execution of the securitisation transaction. In some cases, it would not be appropriate to treat such a support as implicit recourse.

It should be stipulated that the supervisor be able to treat the assets concerned as if they were on the bank's balance sheet after determining the necessity for providing capital related to such a support in light of its effect on the market etc.

It would be excessive to apply such a treatment not only to the support concerned but also to all the securitisation transactions retrospectively.

(Reasons)

Regulatory capital framework aims at maintaining sound bank management.

It would be excessive to impose the penalty on all the securitised assets retrospectively when "recourse for the second time" etc. is discovered. Applying uniformly such an excessive penalty would be detrimental to the development of markets. It would therefore be appropriate to make the treatment subject to the judgement of the relevant supervisor.

[Supporting Document on Asset Securitisation: Paragraph 86]

Criteria that would need to be met in order to obtain a preferential capital charge could include the following (synthetic securitisation).

(a) Ensure the absence of any early amortisation or other credit performance contingent clauses;
(b) Subject the transaction to market discipline through the issuance of a substantive amount of AAA-rated notes or securities to the capital markets;
(c) Have notes or securities rated by two rating agencies;
(d) <u>The SPV, even though highly rated</u>, would not be considered to be an eligible guarantor that would reduce the risk weight of the portion of the reference portfolio hedged credit derivative. In order for this portion of the reference portfolio to obtain capital relief, the vehicle must pledge eligible collateral (i.e. cash or zero-weighted central government securities) to the beneficiary bank.

Request

We request that (a) be removed.

(Reasons)

Credit-linked notes etc. issued for investors may have, like traditional securitisation, a provision for early amortisation (clean up) by reason of prepayment etc. of the underlying assets. Imposing the above restriction only on synthetic securitisation would not be consistent with other types of securitisation, which is not reasonable.

Request

We request that (b) and (c) be removed.

(Reasons)

In many cases, credit-linked notes are issued in the form of private placement (unrated) as in the case with traditional securitisation. Furthermore, it would not be essential to limit the rating only for synthetic securitisation to AAA.

Request

We request that (d) be removed or the underlined part therein be replaced with the following.

"The SPV highly rated due to the credit support by the beneficiary bank"

(Reasons)

It is common that an SPV becomes a counterparty for synthetic securitisation. Requiring SPV to always pledge eligible collateral despite its high rating would undermine the characteristics of this scheme that does not involve transfer of assets. Such a requirement should be limited only to the case where an SPV is highly rated due to the credit support by the bank.

END