July 31, 2003

JBA's Position Regarding The Third Consultative Paper (CP3) On The New Basel Capital Accord

Japanese Bankers Association

Introduction

First of all, we wish to thank the Basel Committee for the time and effort it has devoted to finalizing the New Capital Accord. We also wish to express our gratitude for the opportunities given for dialogue between the supervisory authorities and the banking industry to date.

We strongly support the primary goal of the New Accord, which calls for identifying the risks held by banks accurately, maintaining banks' incentives to enhance their risk management capabilities and assuring stability of the overall financial system. Our sincere hope is that the New Capital Accord will respect and approach the risk management practices that are executed based on their independent internal models.

Our stance this time concerning the Third Consultative Paper (CP3) is that further revisions are necessary before debate on finalizing and implementing new rules get underway in earnest. This is believed to be the case because of the abovementioned primary goal of the New Accord. We sincerely hope that the Basel Committee gives ample consideration to these opinions and reflects them in the final rules.

We are convinced that close dialogue between the supervisory authorities and banks is the key to successful implementation of the New Accord. Risk management is constantly evolving and our hope is that priority will continue to be given to dialogue with the banking industry. It is also our hope that the contents of the Accord continue to be rational and practical, and not diverge from actual practice.

１． Pillar 1 : Minimum Capital Requirement

Most of our comments concern Pillar 1, and support our conclusion that further adjustments to the calculation standards for minimum capital requirements are essential.

The following is considered to be the most important among our comments concerning Pillar 1.

（１） Expanding the scope of recognition for credit risk mitigation

There is considerable concern that excessively conservative limitations on the effect of credit risk mitigation will distort bank practices.

- It is understood that the Foundation Internal Ratings-Based Approach (FIRB) is a kind of transitional approach for the Advanced Internal Ratings-Based Approach (AIRB) and operational requirements for eligible guarantors under FIRB should be consistent with those under AIRB, not with those under the standardized approach. *(detailed comment No.8*)

(2) Simplification/flexible application of minimum requirements for the IRB approach (Section H).

Overall, the requirements stated in section H are excessively prescriptive. For this reason, the minimum requirements will become a major hurdle for banks when considering implementing the New Accord.

The cost of developing computer systems and altering operational procedures as required will be enormous, but there are still concerns that these investments will not necessarily lead to the more sophisticated risk management practices that are the aim of the New Accord. One reason for this is the fact that the broadly prescriptive requirements are not necessarily consistent with the directions banks are taking to increase sophistication of their internal control systems, or with the economic environments and commercial practices of individual countries.

In light of the diversity of banks' internal control systems and the economic environments and commercial practices of individual countries, further simplification and more flexible interpretation of the requirements should be instituted to literally keep the requirements to a “minimum.”

- Excessive conservatism in assigning ratings and estimating PD/LGD/EAD has a substantial impact on banks’ practices because it imposes the significant burden of redundant management on banks. This is also excessive in view of Pillar 2 and must be altered. *(No.12)*
- The approaches taken regarding regulatory capital and banks' economic capital are fundamentally different, so strict application of the USE TEST leads to concern about major inconsistencies. *(No.14)*
- With regards to the application of AIRB, the minimum holding periods of seven years for LGD/EAD data and five years for PD data are clearly excessive in light of the amount of time remaining until implementation of the New Accord. Furthermore, a substantial transitional period is essential along with a relaxation of the minimum requirements. *(No.17)*

(3) Adjustments to supervisory parameters for FIRB

Even though QIS3 may have resulted in reasonable levels "overall," there are areas where the results do not necessarily seem reasonable when one focuses on individual portfolios and comparisons between different measurement methodologies. The New

Accord has greater risk sensitivity than the Current Accord, and there is concern that a minor imbalance in the calculation standards for regulatory capital may cause distortions in the capital requirement, with serious repercussions for actual banking operations.

- Supervisory LGD of 45% for bank exposures under FIRB should be reduced *(No.7)*
- Credit conversion factor for commitment of 75% under FIRB should be reduced *(No.9)*
- Credit conversion factor for eligible liquidity facilities under the FIRB securitization framework should be lowered *(No.27)*

(4) Operational risk related issues

- With regard to operational risk loss events in relation to credit risk, the question of whether to calculate the capital requirement as credit risk or as operational risk should be left to the discretion of each bank. *(No.29)*
- More flexible interpretations should be allowed for the qualifying criteria with regards to handling insurances as operational risk mitigation measures. It should be possible to evaluate insurance policies that possess a strong certainty of continuation as having a residual term in excess of one year irrespective of their contracted period. We also request that minimum notice periods for cancellation and non-renewal of the policy be excluded from the insurance eligibility requirements because, for example, there are insurance policies that are impossible to cancel without agreement of both parties. *(No.31)*

2. Pillar 2: Supervisory Review Process *(No.33)*

Elimination of excessive conservatism from Pillar 1 should be carried out. Based on the assumption that this request is actually accepted, we understand that there are cases where additional capital would be required under Pillar 2 to maintain a certain level of conservatism. The current Pillar 1 is no longer a "minimum capital requirement" because excessive conservatism is required in every quarter of Pillar 1 and this would cumulatively lead to an unreasonable increase in overall regulatory capital. Therefore, we cannot accept greater capital requirements under the treatment currently required in Pillar 2.

In addition, standards and measures for additional capital requirements under Pillar 2 have not been verified for their adequacy under QIS3 and no clear industry standards have been formulated as of yet. There is growing concern that, if the drafted measures in Pillar 2 are applied in a mechanical manner, the supervisory authorities may at their discretion demand increases in capital requirement to the extent that sophisticated calculations under Pillar 1 are rendered invalid.

Consequently, for a certain transition period following implementation of the New Accord, supervisory reviews under Pillar 2 should be applied in a limited scope, and additional capital requirements not be forced on banks without bilateral agreement. The creation of prescriptive rules pertaining to Pillar 2 will not lead to a resolution; rather continued dialogue between the supervisory authorities and banking industry will lead to the reasonable and smooth formation of a consensus. Along with devoting effort to gaining a consensus among national supervisors, continual study and dialog aimed at establishing a grand framework pertaining to the operation of Pillar 2 is requested.

３． Pillar 3: Market Discipline *（No.36）*

The effort that has gone into simplifying some parts of the disclosures indicated in Pillar 3 to a necessary yet adequate level is greatly appreciated. However, there are still many disclosure items that are excessively prescriptive or vaguely defined, so further simplification should be implemented.

There is a danger that interested parties such as financial institutions and investors may be seriously misled by the requirement for excessively prescriptive information disclosures across-the-board. This is particularly true presently as it is impossible to foretell how information disclosures conducted in line with the content of this document will work out overall. In the initial stages of the implementation of the New Accord, financial institutions should be shown the grand framework then given the leeway to make their own stipulations concerning disclosure matters that go beyond that in light of their own internal management systems. An approach should be taken in which disclosure levels are expanded in line with confirming the steady implementation of the New Accord. This should also be effective in ensuring consistency with the work that is currently underway at the International Accounting Standards Board (IASB).

４． Detailed Comments

Please refer to the materials annexed to this paper.

【Detailed Comments】

(Annex)

(Note) Level of Importance : ◎＝Extremely important、○＝Important

【Pillar 1 : Minimum Capital Requirement】

Level of Importance	No.	Headline for Detailed Comment	Relevant Paragraph
Ⅰ. Credit Risk ― Standardised Approach (B. The standardised approach ― Credit risk mitigation)			
	1	Easing eligible financial collateral conditions for mutual funds	116
	2	Treating credit risk mitigation effects in the case of credit derivatives	162(a)
	3	Ensuring consistency in the treatment of operational requirement for credit derivatives	162(c)
	4	Treating credit protection conditional on losses above a material threshold amount	167,83
	5	Revising excessively conservative conditions (basket credit derivatives)	176-179,674
Ⅱ. Credit Risk ― IRB Approach (B. Mechanics of the IRB Approach)			
○	6	Flexible treatment of phased roll-out and partial use for smooth implementation	226-229
Ⅲ. Credit Risk ― IRB Approach (C. Rules for Corporate, Sovereign, and Bank Exposures)			
◎	7	Lowering the supervisory LGD (45%) for the FIRB approach in the case of bank exposure	256-257,QIS3
◎	8	Eligible guarantors under FIRB should not be referred to the treatment under the standardized approach but should be consistent with those under AIRB	271,160-171,445-446
◎	9	Credit conversion factor of 75% for commitment under FIRB should be reduced	281,55-59
Ⅳ. Credit Risk ― IRB Approach (H. Minimum requirements for IRB approach)			
	10	Revision of the description for treating guarantees of corporate purchased receivables	341 (3rd bullet)
○	11	Deleting the obligation for FIRB banks to have transaction-specific rating systems	358,360
◎	12	Avoiding excessive conservatism in estimating PD, LGD, and EAD and in assigning internal ratings	376-378,396-399, 413,430,437
○	13	Easing operational requirements of the rating system for retail exposure	389
◎	14	Easing “use test” requirements	406
	15	Easing requirements pertaining to re-ageing, etc.	420
	16	Revising PD estimate values according to seasoning effects in long-term retail exposure	429

Level of Importance	No.	Headline for Detailed Comment	Relevant Paragraph
◎	17	Relaxing minimum data requirements for PD/LGD/EAD estimation and application of transitional measures when implementing the New Accord	434,440,233,234
	18	Recognizing double default effects	444
○	19	Easing monitoring requirements for purchased receivables	458
	20	Easing collateral management requirements for eligible CRE/RRE	473
○	21	Deleting items imposing excessive operational requirements for FIRB banks to recognize financial receivables	474
○	22	Eliminating excessive complexity of requirements for credit risk mitigation where receivables are pledged as collateral	480,482
○	23	Deleting excessive requirements concerning receivables used as collateral	481
○	24	Easing eligibility requirements for other physical collateral	485
Ⅴ. Credit Risk ― Securitization Framework			
	25	Private ratings should be permitted under the Rating Based Approach (RBA)	525
	26	Lowering risk weights for securitization exposure	581,589
○	27	CCF for eligible liquidity facilities under the IRB securitization framework should be lowered	600-603
Ⅵ. Operational Risk			
	28	Incentive for TSA	615-625
◎	29	Treating operational risk loss events in relation to credit risk	633 (5th bullet)
	30	Treating back-testing using external data	636 (4th bullet)
○	31	Eligibility requirements for insurance	638 (2nd and 3rd bullets)
Ⅶ. Trading Book			
	32	Treating credit derivatives	669,670,671,675

【Pillar 2: Supervisory Review Process】

Level of Importance	No.	Headline for Detailed Comment	Relevant Paragraph
◎	33	Supervisors' approach to additional capital requirements, the appropriate level of sufficient capital and stress tests	715,724,682,690
	34	Treating residual risk under Pillar 2	726-728
	35	Supervisory corrective actions	746

【Pillar 3: Market Discipline】

Level of Importance	No.	Headline for Detailed Comment	Relevant Paragraph
○	36	General Remarks	757,Table 6 (e)

[Pillar 1: Minimum Capital Requirement]

Ⅰ. Credit Risk ― Standardised Approach (B. The standardised approach ― Credit risk mitigation)

1. Easing eligible financial collateral conditions for mutual funds (Paragraph 116)

- Normally, investments in mutual funds are dispersed over many instruments and the covered issues frequently change. Under circumstances like this, it is extremely difficult to confirm whether the mutual funds targeted for investment fulfill the conditions stated in this paragraph. With regard to the second condition given in (f), namely, that "the UCITS/mutual fund is limited to investing in the instruments listed in this paragraph," the fund in question should be treated as eligible financial collateral in cases where its price is published daily and there is a market where the fund can actually be sold at that price.

2. Treating credit risk mitigation effects in the case of credit derivatives (Paragraph 162(a))

- We applaud the Basel proposal that credit risk mitigation (CRM) effects be recognized even when restructuring is not included in the credit events of credit derivatives as long as the bank has control over repayment. Even if the bank has no control, we believe CRM should be allowed with an appropriate discount imposed.

3. Ensuring consistency in the treatment of operational requirement for credit derivatives (Paragraph 162(c))

- The treatment of residual maturity of credit derivatives in paragraph 162(c) and paragraph 174 is inconsistent.
  - ― More specifically, paragraph 174 permits the partial recognition of CRM effects when residual maturity of credit derivatives is less than that of reference assets.
  - ― On the other hand, paragraph 162(c) states that residual maturity of credit derivatives shall exceed the sum of the maturity period and grace period for the underlying assets. This is not consistent with the treatment of paragraph 174.

4. Treating credit protection conditional on losses above a material threshold amount (Paragraph 167, 83)

- Credit default swaps conditional on losses above a certain material threshold amount are equivalent to the retained first loss position and must be deducted in full from the capital. In a case where the losses exceed the applicable material threshold amount, and "the loss amount including applicable material threshold amount is protected," it is not the same as the "retained first loss position." We, therefore, would like it clarified that it is possible to apply the same risk weight as the underlying credit exposure to the material threshold amount.
- Paragraph 83 states that "No transaction in which CRM techniques are used should receive a higher capital requirement than an otherwise identical transaction where such techniques are not

used." Please clarify that this is also valid for Paragraph 167.

5． Revising excessively conservative conditions (basket credit derivatives) (Paragraph 176-179, 674)

- Treatment of first-to-default and second-to-default credit derivatives does not take the correlation between reference names into consideration at all. It is also excessively conservative and inconsistent with actual practice. A certain discount should be applied to the capital requirement.
- Making the acquisition of a rating from an external credit assessment institution a prerequisite for providing credit protection imposes unnecessarily high costs and hinders market development. A clear statement that permits use of internal ratings, or risk measurement approaches that are in line with the rating assignment methods used by external credit assessment institutions should be written.

Ⅱ． Credit Risk ― IRB Approach (B. Mechanics of the IRB Approach)

○ 6． Flexible treatment of phased roll-out and partial use for smooth implementation (Paragraph 226-229)

- When a banking group transfers to a more advanced approach as a whole, phased roll-out should be permitted for smaller portfolios that are material but insignificant in relation to total group assets.
  - ―This is essential in order to avoid situations where it becomes impossible for a banking group as a whole to switch to a more advanced approach owing to smaller portfolios for which adopting a more advanced approach is prohibitive.
- In cases where a group adopts the FIRB approach, group members should be allowed to adopt partial use of the AIRB approach on an entity basis.
  - ―In cases where an overseas subsidiary is obliged under host country regulations to adopt a more advanced approach than the overall banking group intends to adopt under home country regulations, it is necessary to avoid a double regulatory compliance burden imposed both on a consolidated group basis and under host country regulations
  - ―Under FIRB, permanent partial use of AIRB should be allowed for entities according to their activity characteristics. For example, the credit risk mitigation measures in leasing activities are quite different from those assumed under FIRB in terms of recovery methods from leased property.

Ⅲ. Credit Risk ― IRB Approach (C. Rules for Corporate, Sovereign, and Bank Exposures)

◎ **7. Lowering the supervisory LGD (45%) for the FIRB approach in the case of bank exposure (Paragraph 256 -257, QIS3)**

- QIS3 results show that capital requirements for bank exposure under the FIRB approach is increased by 45% on average, which is by far larger than other asset classes and, at the same time, a similar level to the standardized approach.
- Not only does this not assure the appropriate incentive for banks take greater risk-sensitive approaches, the sharp increase in capital charges pertaining to bank exposure could lead to unintended damage to liquidity in the inter-bank market.
- It is therefore recommended that, under the FIRB approach, a supervisory LGD value be separately set for each asset class reflecting the LGD level unique to each. (According to the QIS3 results published by the Basel Committee, the average LGD for bank exposure under AIRB was 36% and, in view of that, the supervisory LGD for bank exposures should be set at around 40% to secure appropriate incentive.)

◎ **8. Eligible guarantors under FIRB should not be referred to the treatment under the standardized approach but should be consistent with those under AIRB (Paragraph 271,160-171,445-446)**

- As FIRB and AIRB are both based on internal ratings and also subject to basically the same minimum requirements as the IRB approach, it is understood that FIRB is a sort of transitional approach towards AIRB that has largely the same concept. In view of this, the requirements for eligible guarantors under FIRB should be consistent with those under AIRB. This treatment is also desirable for smooth transition from FIRB to AIRB.
- Under the FIRB approach, the CRM effect of guarantees is just limited by adjusting PD, i.e., adjustment through LGD is not permitted. On top of this restriction, the far narrower range of eligible guarantors makes FIRB excessively conservative compared to AIRB.
- Also, under the current proposal FIRB banks are to follow largely the same requirements as those of the standardized approach, and it is necessary to check whether or not a guarantor is assigned “external” ratings despite the fact that the approach is in fact based on internal ratings. This is not only burdensome it is also self-contradictory.

◎ **9. Credit conversion factor of 75% for commitment under FIRB should be reduced (Paragraph 281, 55-59)**

- QIS3 results show that the increase in the capital requirement for undrawn commitment is, on a contribution basis, +2.5% under the FIRB approach. This is more than double the +1.1% of the AIRB approach. Although AIRB banks may be given more favorable treatment than FIRB banks as a general incentive, this is clearly excessive and the level playing field between banks that adopt different approaches would be seriously damaged.
- The credit conversion factor (CCF) under the standardized approach is set depending on the

residual maturity, while CCF under the FIRB approach is set uniformly. This treatment is unreasonable with regards to risk sensitivity.

- In CP3, CCF for short-term self-liquidating letters of credit according to the internal ratings approach (IRB) is reduced from 50% to 20%. This has adjusted it to the same level as the standardized approach (Paragraphs 58, 284). A similar adjustment (e.g. 50% or 20%) should be made for commitment CCF levels in this case.

Ⅳ. Credit Risk ー IRB Approach (H. Minimum requirements for IRB approach)

10. Revision of the description for treating guarantees of corporate purchased receivables (Paragraph 341 (3rd bullet))

- The paragraph in question states "(i.e. the risk weights of the uncovered risk components will be added to the risk weights of the covered risk components)." "Risk assets" should be used instead of "risk weights" to clarify the meaning.

○

11. Deleting the obligation for FIRB banks to have transaction-specific rating systems (Paragraph 358, 360)

- This paragraph stipulates that "A qualifying IRB rating system must have two separate and distinct dimensions," but it is excessive to require FIRB banks that are not allowed to use their own estimates of LGD to adopt a rating system for transaction specific factors. FIRB banks should only be required to adopt a rating system for the risk of borrower default

◎

12. Avoiding excessive conservatism in estimating PD, LGD and EAD and in assigning internal ratings (Paragraph 376-378, 396-399, 413, 430, 437)

- The requirements for conservatism in estimating parameters such as PD, LGD, etc. and in assigning internal ratings under Pillar 1 are excessive and, therefore, simplification (or otherwise deletion) is strongly requested for some of the requirements. (Please see below for the details.)
- If otherwise, banks would be forced to adopt double standards to estimate parameters and assign internal ratings, of which one is for regulatory capital purposes while the other is for such purposes as credit judgment, credit pricing, provisioning, etc. This not only runs counter to the "use test" required in paragraph 406, but also imposes on banks the significant burden of redundant management. It is therefore requested that estimation of parameters and assignment of ratings for regulatory capital purposes be consistent with banks' internal management processes.
- As for assuring conservatism, banks' internal risk management should be respected in the first place and be followed by an overall supervisory judgment made under the framework of Pillar 2. There is great concern about the excessive conservatism required in every quarter of Pillar 1 and that this cumulatively would lead to an unreasonable increase in overall regulatory capital.

ー The excessive conservatism required in the ratings assignment stage in Paragraphs 376-378 should be corrected.

− Paragraphs 396-399 require the implementation of stress testing, but this should be abolished because it should be carried out within the framework of Pillar 2.

− Paragraphs 413 and 437 make it obligatory to add a margin of conservatism to estimates of PD, LGD and EAD because of the possibility of unpredictable errors. Only “consideration of the need for an additional margin” should be obligatory. Reasonably conservative estimates should only be obligatory in cases where data, etc., are actually insufficient.

− Paragraphs 430 and 437 state that for exposures of which LGD and EAD are volatile over the economic cycle, the bank must use estimates that are appropriate for an economic downturn if those are more conservative than the long-term average. This obligation should be deleted. LGD and EAD generally fluctuate with the economic cycle, and we would like the long-run average to always be employed in estimation (Paragraph 409).

○ 13. Easing operational requirements of the rating system for retail exposure (Paragraph 389)

▪ This paragraph states that "[a bank] must also review the status of individual borrowers within each pool as a means of ensuring that exposures continue to be assigned to the correct pool [on an annual basis]." This requirement is excessive and the second and subsequent sentences of this paragraph should be deleted.

− In managing pools, not only is it pragmatically difficult to review individual material components (borrowers), but it is also difficult to envisage using the results of a sample survey for any kind of response.

− At the very least, in cases where pool attributes that do not vary with age are defined and management of the pool through maturity is a precondition, it should be clarified that it is unnecessary to review samples regularly.

◎ 14. Easing “use test” requirements (Paragraph 406)

▪ We agree that ratings systems and parameter estimates play an important role in the IRB approach, and thus should be widely used in internal controls. However, since supervisory parameters are used mechanically under FIRB, use of the parameters in question in a bank's internal capital allocation can be seen as running counter to the increasing sophistication of the bank's own internal controls.

15. Easing requirements pertaining to re-ageing, etc. (Paragraph 420)

▪ Paragraph 420 states that “(b) the minimum age of a facility before it is eligible for re-ageing, (c) the delinquency levels of facilities that are eligible for re-ageing, and (d) the maximum number of re-ageings per facility” must be, at a minimum, included in the re-ageing policy. In light of the diversity of banking practices in different countries, the statement includes items that are not essential in some jurisdictions. Therefore, some of the contact lacks meaning and is inappropriate or excessive. We recommend their deletion or limited use as examples (for instance by altering the second sentence to "For instance, the re-ageing policy may include...").

16. Revising PD estimate values according to seasoning effects in long-term retail exposure (Paragraph 429)

- We agree that there may be cases of PD estimates where seasoning effects are quite material for certain long-term retail exposures. However, we would like clarification of the possibility that downward revisions of PD estimates may occur as well as upward revisions (depending on the seasoning effects) in such cases.

◎

17. Relaxing minimum data requirements for PD/LGD/EAD estimation and application of transitional measures when implementing the New Accord (Paragraph 434, 440, 233, 234)

- Paragraphs 434 and 440 determine that corporate, sovereign, and bank LGD and EAD data must be accumulated over a period of at least 7 years. However, the following 2 modifications should be made.
  - Relax the required period from a minimum of 7 years to a minimum of 5 years. There is no clear basis for setting the standard at 7 years, and may be considered excessive when the burden of accumulating data is taken into mind. It should be made 5 years, as is the case with PD and retail cases.
  - In addition, an exception should be provided that allows for a data accumulation period of less than 5 years when the data accumulation period includes the bottom of a recession and sufficient data for estimation is obtained. The concept of a default-weighted average is adopted for estimation of LGD/EAD from the point of view of reflecting concentrated defaults during a recession and deterioration of risk characteristics. Based on this, it is conceivable that adequately conservative data can be accumulated even in a relatively shorter period of time, if the period includes an economic recession.
- In Paragraph 234 the required period for data accumulation for specific risk components is relaxed to 2 years at the implementation of the New Accord, and increases one year for each of the next 3 years in a transitional arrangement. However the scope of application of the transitional arrangement defined in separate Paragraph 233 appears to be insufficient. Therefore, the following 2 modifications should be made.
  - This transitional arrangement is limited to application to retail for LGD/EAD but it should also apply to corporate, sovereign and bank LGD/EAD. (Also, the data accumulation period after completion of the transitional arrangements should be relaxed from 7 years to 5 years as stated above.) Considering there are only 2 years granted from the finalization of the New Accord (end of 2003) to the first implementation of the parallel runs (end of 2005), the same transitional arrangements as those used with retail should be applied for corporate, sovereign and bank LGD/EAD.

– The application of transitional arrangements for corporate, sovereign and bank PD are limited to the FIRB approach, but they should be applied to AIRB as well. For the same reasons as mentioned above, AIRB should be subject to the same transitional arrangements as FIRB for corporate, sovereign and bank PD data. This arrangement is also appropriate from the point of view of consistency with retail.

18. Recognizing double default effects (Paragraph 444)

- Although Paragraph 444 provides that the effect of double default may not in any way be permitted, a certain degree of effect should be allowed.
- In June 2003, the US authorities published a research paper on the treatment of this effect, and we welcome such moves. We hope that this framework will be incorporated into the New Accord at an early stage following dialog with the banking industry.

○ 19. Easing monitoring requirements for purchased receivables (Paragraph 458)

- Overall, the minimum requirements for eligible purchased receivables are excessive. In particular, due to practical limits to collecting information from the seller. We recognize the need for the obligation to verify the quality of the seller's credit policies and servicer's collection policies, but these matters pertain to other companies' control and consideration should be given to the business practices of individual countries. Minimum requirements should be simplified or it should be permissible to take into consideration the circumstances in individual countries (national discretion).
- Furthermore, regulations that impose a high hurdle on banks only lead to competitive inequality between banking and non-banking sectors.

20. Easing collateral management requirements for eligible CRE/RRE (Paragraph 473)

- While this paragraph states that "the bank must take steps to ensure that the property taken as collateral is adequately insured against damage or deterioration," this portion should be deleted because frequent revaluations (at least once a year) have already been made obligatory (included in Paragraph 472) with a view to preventing damage or deterioration from occurring.

○ 21. Deleting items imposing excessive operational requirements for FIRB banks to recognize financial receivables (Paragraph 474)

- The provision stating that "Eligible financial receivables are claims with an original maturity of less than or equal to one year" should be deleted. The receivables used as collateral are extremely numerous and banking computer systems would find it very burdensome to manage their maturities.

○ **22. Eliminating excessive complexity of requirements for credit risk mitigation where receivables are pledged as collateral (Paragraph 480, 482)**

- The criteria for recognizing credit risk mitigation where receivables are pledged (Paragraphs 480 and 482) are excessively complex and the paragraphs in question should be deleted.
  - Paragraph 480 requires that the margin between the amount of the exposure (e.g. commercial bill discounting in Japan) and the value of the receivables must reflect all appropriate factors including:
    - ✧ Concentration within the receivables pool pledged by an individual borrower, and
    - ✧ Potential concentration risk within the bank's total exposures.

    While the concentration risk of underlying obligors should be properly checked in banks' credit risk management processes, this could make the regulatory framework excessively complex. Moreover, it is quite difficult to precisely quantify and reflect the degree of concentration to the margin between exposure and collateral in a risk sensitive manner.
  - Paragraph 482 requires (in the case of receivables pledged) the correlation risk to be taken into account when setting margins for a collateral pool where the borrower and the issuers belong to a common industry. This, however, is an excessive requirement and it is also extremely difficult to quantify a reasonable margin. As a consequence, removal of this description is strongly recommended.

○ **23. Deleting excessive requirements concerning receivables used as collateral (Paragraph 481)**

- The collateral management examples described here are similar to factoring management practices and are excessive as requirements for management levels of collateralized receivables. "This process may include," and the concrete examples given thereafter should be deleted.

○ **24. Easing the eligibility requirements for other physical collateral (Paragraph 485)**

- If the same level of management as for DRE/RRE (shown in Paragraph 472) is in place, junior liens (i.e., ones not limited to first charge) should be allowed for other collateral, also.
- In Paragraph 485, it is stated that "The loan agreement must include detailed descriptions of the collateral plus detailed specifications of the manner and frequency of revaluation." However, it is excessive to require details such as the manner and frequency of revaluation of collateral to be stipulated in a particular loan agreement and deletion of this description is strongly recommended.
- The text states that "the appropriate amount of each type of collateral relative to the exposure amount must be clearly documented in internal credit policies." However, the absolute credit risk mitigation effect of collateral is not determined by a relative size or coverage of the collateral compared to the corresponding exposure amount. Furthermore, although clearly securing a certain level of LTV (loan-to-value) ratio is critical in some transactions like aircraft finance, it is not reasonable to incorporate such criteria, as a rigid quantitative requirement in

general internal credit policy. Therefore, deletion of this description is imperative.

- In light of country-based differences in banking practices regarding collateralization, overly rigid descriptions should be avoided in the New Accord and certain flexibility should be allowed as long as appropriate risk management is realized in a particular jurisdiction.

Ⅴ. Credit Risk － Securitization Framework

25. Private ratings should be permitted under the Rating Based Approach (RBA) (Paragraph 525)

- In connection with the ratings that can be used with ratings-based approach (RBA), this paragraph states that "private ratings" will not qualify. From the investor side, however, while there are differences depending on whether the rating is published or not, there is no essential difference in the rating and monitoring process. The investments have been made on this assumption.
- As for existing deals, bearing in mind the current situation where banks have played an important role as investors in securitised products, there is concern that this uniform treatment of private ratings may not only have an adverse impact on the future development of the securitization market, but could also cause unexpected confusion in the market through a sudden liquidation of positions banks already hold.
- Therefore a practical response that reflects the current situation by, for example, allowing the use of private ratings for existing deals, is necessary.

26. Lowering risk weights for securitization exposures (Paragraph 581, 589)

- A comparison of securitization exposures with corporate exposures that hold the same credit rating reveals that the risk weight difference for below-investment grade ratings (BB+ and below) is still excessive. Therefore, the risk weights for securitization exposures should be lowered. Furthermore, there is a similar excessive difference in the risk weights for the portion equivalent to below-investment grade ratings under the supervisory formula approach (SFA). These risk weights should also be lowered.

  －There are concerns that excessively conservative risk weights may inhibit the originators' active credit formation functions and the investors' willingness to invest, hindering the healthy and stable development of the securitization market.

○ **27. CCF for eligible liquidity facilities under the IRB securitization framework should be lowered（Paragraph 600-603）**

- With regard to CCF for eligible liquidity facilities under the IRB securitization framework, a 50% CCF should be newly established for cases where the eligible criteria are met.

  － An eligible liquidity facility that can only be drawn in the event of a general market disruption is assigned a 20% CCF under the IRB approach, while other facilities are assigned a 100%

CCF (see table below).

【CCF for eligible liquidity facilities】

	Eligible Liquidity Facilities			Others
	Original maturity is one year or less	Original maturity is more than one year	Available in the event of market destruction	
Standardized approach	20%	50%	0%	100%
IRB	100%	100%	20%	100%
IRB (our proposal)	50%	50%	20%	100%

— Under the standardized approach, detailed rules are set for CCF depending on the original maturity and whether the eligible criteria are met or not (i.e. it is risk sensitive). Under the IRB approach, however, not only is there no risk sensitivity but there is also no incentive to limit risk by satisfying the eligible criteria.

— In cases where the eligible criteria are met, a 50% CCF should be newly established to keep a balance with the standardized approach. A 50% CCF is an intermediate value between 20%, which is applied in the event of market disruption, and 75%, which is applied in general commitments that are less restricted than eligible liquidity facilities.

Ⅵ. Operational Risk

28. Incentive for TSA (Paragraph 615-625)

- The standardized approach (TSA) sets qualifying criteria that are close to those of the Advanced Measurement Approaches (AMA), but there is no major difference between the capital requirement levels of TSA and the Basic Indicator Approach (BIA). It is necessary to review the BIA and TSA factors (beta and alpha) and assure an incentive for selecting the more risk-sensitive approach.

◎

29. Treating operational risk loss events in relation to credit risk (Paragraph 633 (5th bullet))

- With regard to operational risk loss events in relation to credit risk, the question of whether to calculate the capital requirement as credit risk or as operational risk should be left to the discretion of each bank so long as it is handled reasonably and consistently within each bank. Since various cases of operational risk loss events related to credit risk can be envisaged, it is difficult to establish an industry standard.
- Moreover, in cases where operational risk loss events related to credit risk are not included in operational risk capital requirements, it is obligatory to record them also in the bank's operational risk management database. This duplicates management procedures both for credit risk and operational risk and thus requires excessive risk management levels. Banks themselves should decide where to record risk loss data in accordance with their internal risk management

systems and procedures. Therefore, the text beginning with "Nevertheless, …" should be deleted.

30. Treating back-testing using external data (Paragraph 636 (4th bullet))

- While we do not reject back-testing per se, there are currently no reliable external loss databases in existence, making it impossible for financial institutions to make validations by themselves in comparisons with external loss data. Consequently, it is inappropriate to include this requirement among the qualifying criteria.
- This requirement should be replaced by confirmations of internal control conditions within the framework of validations by supervisors and external audits of capital ratio calculations.

○ 31. Eligibility requirements for insurance (Paragraph 638 (2nd and 3rd bullets))

- For some types of insurance, continuation is sometimes a precondition, such as one-year policies with automatic renewal, etc. Evaluation of insurance policies with a high degree of certainty of continuation should be allowed to judge the policies to have a residual term in excess of one year irrespective of the policy term.
- Minimum notice periods for cancellation and non-renewal of the policy should be excluded from the insurance eligibility requirements. We recognize that the purpose of these standards is to judge the continuity of insurance, but judgments should be made after taking the overall content/conditions of the policy into consideration comprehensively, and simply mechanically adopting a minimum notice period as an eligibility requirement is inappropriate.
  - Even in cases where no minimum notice period has been established, for example, there are no problems with policy continuity as long as it is stipulated that it is impossible to cancel the policy unless both parties have agreed.

Ⅶ. Trading Book

32. Treating credit derivatives (Paragraph 669, 670, 671, 675)

- With regard to the treatment of credit derivatives in the trading book, please clarify the conditions that allow the offsetting of specific risk for credit derivatives in the case of offset ting trading positions.
  - Paragraph 669(a) provides that full allowance will be recognized as long and short positions of credit derivatives consist of “completely identical instruments.” However, the meaning of “completely identical instruments” is not clear enough and needs to be clarified.

    More specifically, the similar rules in Paragraph 21 of “A.1: Interest rate risk,” “Part A: The Standardized Measurement Method,” of “Amendment to the Capital Accord to Incorporate Market Risks” by the Basel Committee on Banking Supervision in January 1996 should be applied. In other words, the following treatment should be specified. In cases where long and short positions in credit derivatives use the same reference entity and the same seniority of the (deliverable) obligations, netting of the position is possible so long as the residual maturity of the transaction in question is within the limits stipulated in (1) through (3) below.

(1) When the residual maturity of each position is less than one month, the same day is required.

(2) When the residual maturities of both positions or maturity of either position are/is between one month and one year (excluding the case applied in the above case (1)), a difference of within seven days is allowed.

(3) When the residual maturities of both positions are over one year, a difference of within thirty days is allowed.

— On the other hand, Paragraph 670 provides for recognition of an 80% offset of specific risk "when the value of two legs … always moves in the opposite direction but not broadly to the same extent." Since "not broadly to the same extent" is unclear as a quantitative standard, it should be clarified.

— Furthermore, Paragraph 671 provides conditions for "partial allowance" for specific risk associated with two legs. Since "partial allowance" leaves it unclear as to the percentage of specific risk that may be offset in concrete terms, this needs to be clarified.

▪ In regard to credit derivatives in the trading book, the credit default swap add-on factors for protection sellers of 5% or 10% stated in Paragraph 675 should be capped at the amount of unpaid premiums because counterparty risk for protection the seller does not exceed the amount of unpaid premiums.

【Pillar 2: Supervisory Review Process】

◎ 33. Supervisors' approach to additional capital requirements, the appropriate level of sufficient capital and stress tests (Paragraph 715, 724, 682 , 690)

▪ It cannot be denied that there is duplication and an uncertainty in the requirements pertaining to assuring conservatism in Pillar 1 and Pillar 2. Elimination of excessive conservatism from Pillar 1 should be carried out. Based on the assumption that this request is actually accepted, we understand that there are cases where additional capital would be required under Pillar 2 to maintain a certain level of conservatism. The current Pillar 1 is no longer a "minimum capital requirement" because excessive conservatism is required in every quarter of Pillar 1 and this would cumulatively lead to an unreasonable increase in overall regulatory capital. Therefore, we cannot accept greater capital requirements under the treatment currently required in Pillar 2.

▪ In addition, standards and measures for additional capital requirements under Pillar 2 have not been verified for their adequacy under QIS3 and no clear industry standards have been formulated as of yet. There is growing concern that, if the drafted measures in Pillar 2 are applied in a mechanical manner, the supervisory authorities may at their discretion demand increases in capital requirement to the extent that sophisticated calculations under Pillar 1 are rendered invalid.

▪ Consequently, for a certain transition period following implementation of the New Accord, supervisory reviews under Pillar 2 should be applied in a limited scope, and additional capital requirements not be forced on banks without bilateral agreement. The creation of prescriptive rules pertaining to Pillar 2 will not lead to a resolution; rather continued dialogue between the supervisory authorities and banking industry will lead to the reasonable and smooth formation of a consensus. Along with devoting effort to gaining a consensus among national supervisors, continual study and dialog aimed at establishing a grand framework pertaining to the operation of Pillar 2 is requested.

- There are no objections to requiring banks to adopt appropriate risk management systems for risk factors not covered by Pillar 1, but careful consideration related to requiring banks to increase capital for risk factors that are difficult to be quantified in the first place is essential. When a consensus on standard quantification models has been reached through dialogue with the banking industry, this should be incorporated into Pillar 1. This is clearly a future task.
- In reviewing whether capital is adequate, overall excesses or deficiencies of required capital should be netted-off while respecting banks' independent risk judgments and internal risk management models. Capital requirements should not be added solely from the viewpoint of conservatism. If this is not achieved, there is a possibility that bank willingness to adopt more sophisticated risk management methods where banks themselves identify and measure new risks, and build up capital will erode. Capital requirements under Pillar 2 are primarily calculated using banks' internal control methods, and are essentially different from the capital requirements according to the supervisory risk-weight function based on Pillar 1.
- The credit risk stress test under the IRB approach referred to in Paragraph 724 should be prudently treated because appropriate operational methods have not been established.

34. Treating residual risk under Pillar 2 (Paragraph 726-728)

- These paragraphs require credit risk mitigation effects using collateral and guarantees to be treated more conservatively, but this should be deleted since Pillar 1 already requires thoroughly conservative treatment.
  - Under FIRB, there are strict qualifying criteria that do not take into consideration the correlation of defaults in respect of collateral, guarantees and credit derivatives. Moreover, the recognition of the CRM effect itself is conservative. Consequently, even with excessive coverage of 140% using eligible real estate, the CRM effect only reduces LGD from 45% to 35%.
  - Under AIRB, since LGD and EAD are estimated using data resulting from the inclusion of the bank's residual risk (e.g. including the loss if the guarantor rejects or delays payment), taking residual risk into consideration under Pillar 2 leads to double counting.

35. Supervisory corrective actions (Paragraph 746)

- Paragraph 745 refers to penalties for implicit support, but Paragraph 746 gives examples of penalties when a bank is found to have provided implicit support on more than one occasion. There is no objection to supervisors having various kinds of authority for requesting banks to rectify their behavior, but this is redundant and lacks balance with other descriptions. Please delete it.

【Pillar 3: Market Discipline】

○ 36. General Remarks (Paragraph 757, Table 6(e))

- The effort that has gone into simplifying some parts of the disclosures indicated in Pillar 3 to a necessary yet adequate level is greatly appreciated. However, there are still many disclosure items that are excessively prescriptive or vaguely defined, so further simplification should be implemented.
- There is a danger that interested parties such as financial institutions and investors may be seriously misled by the requirement for excessively prescriptive information disclosures across-the-board. This is particularly true presently as it is impossible to foretell how information disclosures conducted in line with the content of this document will work out overall. In the initial stages of the implementation of the New Accord, financial institutions should be shown the grand framework then given the leeway to make their own stipulations concerning disclosure matters that go beyond that in light of their own internal management systems. An approach should be taken in which disclosure levels are expanded in line with confirming the steady implementation of the New Accord. This should also be effective in ensuring consistency with the work that is currently underway at the International Accounting Standards Board (IASB).
  - The items currently proposed for disclosure include a considerable amount of information similar to the analytical figures handled by specialist departments within the banks, such as the sum of outstanding loans and EAD on undrawn commitments across PD grades (first bullet point in Table 6(e)) and the default-weighted average EAD (third bullet point in Table (e)). Even if they are suitable for regulatory reports, they are clearly not appropriate for disclosure to general investors.
  - Considerable cost and energy will also be necessary for preparing the disclosure system. Other competitive sectors are not required to disclose this kind of prescriptive information and erosion of the banking sector's competitiveness may occur if only banks are disclosing excessively prescriptive information.
  - Ultimately, in respect to some of the disclosure requirements, differences in definition are likely to emerge among different countries and banks. The present extent of prescriptions for disclosures may reduce comparability.