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Basel Committee on Banking Supervision
Bank for International Settlements

CC: Japan FSA
Bank of Japan

13th March, 2009

Comments on BCBS's two consultative documents: "Revisions to the Basel II market risk framework" and "Guidelines for computing capital for incremental risk in the trading book"

Dear Sirs/Madams,

This letter is submitted in response to the BCBS' s requests of comments on the two consultative documents: "Revisions to the Basel II market risk framework" and "Guidelines for computing capital for incremental risk in the trading book". We would like to express our gratitude for this chance to share our views on the issues highlighted by the above two documents with the BCBS. As the current financial crisis has led to this unprecedented period, sincere discussions between regulators and private sectors to address weaknesses of the current prudential framework has become more important than ever. We hope that our comments would be of some help to drive such discussions before finalizing these documents.

General comments

BCBS' reactions described in the two documents in response to the current market turmoil were correctly motivated to address the issues of trading book transactions, for which the risks were not well recognized and controlled in some countries. However, we found that some actions proposed by the documents are not necessarily in line with the general principles long followed by the BCBS in the past.

The BCBS has frequently emphasized that new measures to enhance Basel II should not be procyclical nor prescriptive. Possible significant increases in required capital (see our specific comments for more details) due to the revisions to the Basel II market risk framework from the end of 2010, however, could negatively impinge on the lending capability of some private financial institutions. Such one-off significant increases in the required capital with short notice (and maybe still in the midst of financial crisis) may derail the fragile stability of the financial system, which is expected to be improved by a series of emergency measures taken by major countries recently.

Also, since some revisions request financial institutions to increase capital against trading book exposures regardless of their relations to the current market turmoil, we are concerned that even some financial institutions which have been carrying out their businesses in relatively stable markets or countries so far, may suffer from repercussions of the crisis through "regulatory" changes.

For all these reasons, we wonder if it may be better to delay the timing of implementation of the revisions at least until all major countries have declared "the end of the crisis".

We also believe (and hope the BCBS agrees) that regulatory capital requirements should reflect "real risk amounts" and basically should not be biased toward being lenient nor excessively conservative. Conservative treatments, at first glance, might work better at least for regulators. However, the truth depends on the balance between the treatment of various transactions. Excessively conservative treatment of certain risks against the others only creates arbitrage and inefficiency in the economy.

We do understand that the BCBS rightly acknowledges the possible underestimation of risks for certain transactions in the current regulatory framework, which needs to be

addressed. However, we believe that the corrective measures should be well-balanced and economically reasonable.

Specific comments

1. Treatment of securitization exposures (“Revisions to the Basel II market risk framework”)

According to Section III “Changes to the standardized measurement method for market risk” of the document, all banks regardless of adopting the standardized measurement approach or internal model approach for market risk are required to apply the capital charges defined for the IRB or SA for the specific risk of securitization exposures. In other words, there will be no differences in the capital requirements between trading and banking book transactions as far as securitization exposures are concerned.

This new treatment of securitization exposures is understandable as many financial institutions in some countries are likely to arbitrage the difference in capital requirements between trading and banking book transactions by recording a large number of transactions in the trading book, which should have been recorded in the banking book. The introduction of the equal treatment of securitization exposures between the trading and banking book account might be the only way for some authorities to deter such behavior of financial institutions.

However, in some regions, no such behaviors have been observed among the financial institutions as far as securitization exposures are concerned. Moreover, financial institutions and other market participants in some regions have grown their local securitization markets in a very conservative manner such that not-so-rapid but secure and stable developments have been observed. For these markets, preferential capital treatment for trading against banking book transactions is very important to support their developments as it encourages more parties to be involved in transactions and thereby increases market liquidity.

Under normal circumstances, lower capital requirements for trading compared to banking book transactions should economically be quite reasonable as their holding

period for trading could be significantly shorter than those for banking book transactions. This idea has also long been reflected in the Basel II capital requirements, and still remains even in the newly proposed capital requirements for incremental risk, which introduced the idea of the liquidity horizon in addition to the capital horizon. We do agree with the BCBS that overall current capital requirements for securitization products are likely to be underestimated. However, this underestimation should be addressed in a comprehensive way including the treatment of banking as well as of trading book transactions.

Based on the above observations, we would like to propose that the current proposal should be applied only on the conditions that the authorities actually observed or are seriously concerned about regulatory arbitrage of their supervising institutions. We hope that the Basel Committee, as before, would continue to pay due attentions to the possibility that some measures against specific phenomenon of specific countries could negatively impact on the financial development of other countries, of which voices are not necessarily strong enough to be heard in the international fora.

2. Quantitative standards applied to the model used for the internal models approach (“Revisions to the Basel II market risk framework”)

According to Section IV: “Changes to the internal models approach to market risk” of the document, banks using the internal model approach are required to use the **sum** of “VaR x multiplier” and “Stressed VaR x multiplier” for the capital calculation instead of “VaR x multiplier” in the current treatment. This new treatment would significantly increase the amounts of capital requirement (at least double).

Since the outcome of VaR and stressed VaR are not defined exclusively of each other, it must be very hard for many financial institutions to align this result with their measurement of “real risk amounts”. Unfortunately, the BCBS has not offered us any economically reasonable explanations on this treatment.

Again, we do agree with the Basel Committee that overall, the current capital requirements for trading book transactions are very likely to be underestimated. As stated previously, we believe that this underestimation should be addressed in a comprehensive manner including the IRC, which should cover the majority of risks

materialized during the current crisis. Otherwise, this treatment could unfairly penalize the institutions which are mainly involved in trading of, for example, high-quality bonds (e.g. government securities).

For the above reasons, we would like to propose that the capital requirements should be equal to the higher of (1) VaR x multiplier or (2) Stressed VaR x multiplier instead of the sum of (1) and (2).

3. Adjustment to the current valuation of less liquid positions (“Revisions to the Basel II market risk framework”)

Section B. Adjustment to the current valuation of less liquid positions in Section VII: “Treatment for illiquid positions” of the document indicates that “[t]his adjustment may be **in addition to** any changes to the value of the position required for financial reporting purposes and should be designed to reflect the illiquidity of the position” (718(xcxx) in Page 24). This also indicates that “[t]he adjustment to the current valuation of less liquid positions made under paragraph 718 (xcxxi) must impact Tier 1 regulatory capital and may **exceed** those valuation adjustments made under financial reporting accounting standards ...” (718(xcxxii) in page 24).

The above statements seem to be not in line with the international policy initiatives based on the concerns of the procyclical nature of the current accounting system. Also, suggestions of some possible deviations from accounting values without any clear explanations of exact cases could bring in another uncertainty to be managed by financial institutions, which have already been dwarfed by unprecedented uncertainties.

For the above reasons, we would like to propose that the document should delete the above two sentences.

4. Capital horizons for computing capital for incremental risk in the trading book (“Revisions to the Basel II market risk framework”)

According to Section B. “key supervisory parameters for computing IRC” in Section II “Principles for calculating the IRC” of the document, financial institutions are required to calculate capital assuming a 1-year capital horizon as well as a liquidity

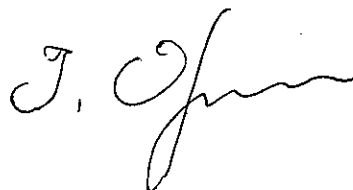
horizon (at least three months). The reason why the liquidity horizon could not be equal to the capital horizon might be that financial institutions were deemed unlikely to stop or significantly change their businesses during the course of the year.

However, the actual events observed in the financial crisis indicated that financial institutions could stop or significantly downsize “new” transactions, which should be the main source of risk to be captured by the capital horizon (or a longer horizon than the liquidity horizon). Meanwhile, mainly because of the unexpected depletion of market liquidity, many institutions faced difficulties in disposing their existing positions, which should be the main source of risk to be captured by the liquidity horizon.

Based on the above observations, we would like to propose that the market risk framework should request banks to use only the liquidity horizon reflecting market liquidity conditions to measure the required capital assuming that the liquidity horizon is equal to the capital horizon. This treatment should significantly simplify the process of measuring capital for the incremental risk.

If you have any questions, please do not hesitate to contact us.

Best regards,

A handwritten signature in black ink, appearing to read "J. O'Connell". The signature is written in a cursive style with a large, sweeping flourish at the end.