



April 16, 2010

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Opinions on Basel Committee on Banking Supervision Consultative Documents

Mitsubishi UFJ Financial Group, Inc. (MUFG) would like to express its appreciation for the opportunity to comment on the consultative documents published by the Basel Committee on Banking Supervision on December 17, 2009, entitled "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring."

At the same time, we would like to express our respect for the initiative of the Committee, which we think could be an important step forward in the task of redesigning global banking regulations based on the lessons learned from the financial crisis.

However, we believe that the new regulatory framework should be designed with consideration given to the different risk profiles of the business models of commercial banks and investment banks. Systemic risk should be avoided by using multiple regulatory measures, not depending excessively on capital regulation.

MUFG hopes that our attached comments will be given due consideration and will prove effective for the consultative process to be carried out by the Committee.

Sincerely,

A handwritten signature in black ink, appearing to be "Saburo Sano", written over a horizontal line.

Saburo Sano

Senior Managing Director and Chief Risk Management Officer
Mitsubishi UFJ Financial Group, Inc.

Opinions on Basel Committee on Banking Supervision Consultative Documents

- ☐ **Strengthening the resilience of the banking sector**
- ☐ **International framework for liquidity risk measurement, standards and monitoring**

April 16, 2010

Mitsubishi UFJ Financial Group

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1. Executive summary

(1) Overall comments

- ✧ With the introduction of multiple regulations, even if each regulatory proposal is rational, there are concerns that their cumulative effect may be to destabilize the financial system.
- ✧ The new framework should not depend excessively on regulation of equity capital. Instead, financial system stability should be ensured by using a range of regulatory tools.
- ✧ The new framework should be even-handed, with consideration given to the different risk profiles of the business models of commercial banks and investment banks.

(2) Quality of capital

(a) Grandfathering

- ✧ The grandfathering period for raising capital under the existing regulations should be the period until the new regulations enter into effect.

(b) Limits and minima

- ✧ The new regulations are supposed to improve the quality of capital and strengthen risk capture. Thus, minimum capital ratios should not be raised.

(c) Tier 1 additional going concern capital and Tier 2 capital

- ✧ Preferred stock, which is classified as shareholders' equity in each country's company law, has loss absorbency features and should be permitted for inclusion in Tier 1 additional going concern capital.
- ✧ If Contingent Capital (defined herein as instruments with mandatory conversion to common equity or write-down features) is to be included in the definition of Tier 1 additional going concern capital or Tier 2 capital, this must be assessed from the perspective of the market and investors and it is appropriate that a test period is established to determine whether an issuance market of sufficient scale and stability for such instruments can be fostered.

(d) Regulatory adjustments

Overall

- The regulatory adjustments should not all be applied to common equity. Given that loss absorbency problems arise at times of financial troubles or bankruptcy, we believe that it is more appropriate that some regulatory adjustments apply to common equity, some to Tier 1 additional going concern capital, and some to Tier 2 capital.

Minority interests

- It would be appropriate that minority interests are either included in Tier 1 capital or an equivalent amount of risk assets is deducted from the denominator.

Other comprehensive income

- The treatment of unrealized gains and unrealized losses should be symmetric.

Intangibles (software)

- As software is treated differently in the accounting standards of different countries and it is an asset that generates cash flow, it should not be a regulatory adjustment item.

Deferred tax assets (DTAs)

- As the characteristics of DTAs as assets are supported by an external audit, and from the perspective of ensuring international comparability, it would be appropriate to use a method that recognises the full amount of DTAs within common equity. If they are required to be limited from a conservative point of view, it would be appropriate to use a method that recognises DTAs up to 20% of either Tier1 capital or common equity before deductions of the regulatory adjustments.

Double gearing

- As the proposed treatment of double gearing would present an obstacle to sound incentives for financial institutions to expand their business through capital alliances, careful consideration is required based on the structure of the financial system in each country, and options such as only including investments in domestic financial institutions within the scope of this item should be considered.

Defined benefit pension fund assets

- Full consideration should be given to the differences in defined benefit pension accounting systems in different countries. As problems regarding the loss absorbency of such assets will only arise upon bankruptcy, if defined benefit pension fund assets are to be applied as a regulatory adjustment, they should be applied to Tier 2 capital.

(3) Risk capture

Credit valuation adjustment (CVA) risk capture

- ✧ Similar capital charges should not be required for derivative transactions used as hedges for the ordinary transactions of a firm ("real demand") and derivative transactions for speculative purposes.
- ✧ The Committee proposes to measure the risk of a change in market value of derivatives from three angles: general market risk, specific risk, and CVA risk. However, this proposal overestimates the associated risk, such as by setting a holding period of one year for CVA risk and

double counting general market risk, and therefore it should be corrected.

Increasing the asset value correlations of financial firms

- ✧ Instead of raising risk weightings by increasing the asset value correlations, excessively low long-term average PD assumptions should be increased by preparing minimum parameters for borrower classification and PD estimation.

(4) Leverage ratio

- ✧ As there is a lack of consistency between the treatment of high-quality liquid assets such as government bonds and the proposed regulations on liquidity, holdings of low-risk, highly liquid assets such as government bonds should be deducted from total assets (the denominator).
- ✧ Leverage ratio should be positioned as indicators to be used in monitoring by national supervisors in a manner attuned to a country's individual circumstances.

(5) Constraining procyclicality

- ✧ If appropriate provisions are made based on the premise of stringent asset assessment, there will be a sufficient level of capital buffers on an accumulated basis, and it will not be necessary to require the establishment of additional capital buffers.
- ✧ Capital buffers should be variable, not set at fixed ratios, and their introduction should not, in effect, serve to raise the minimum capital requirement.

(6) Liquidity regulations

Liquidity Coverage Ratio (LCR)

- ✧ The stress scenario assumptions in the proposal are excessively conservative. Minimum standards that would not impede funding liquidity should be adopted.
- ✧ Stress scenarios that take into account actual circumstances, such as the low run-off rate of customer deposits in Japan, should be adopted.

Net Stable Funding Ratio (NSFR)

- ✧ This indicator should be relaxed, as in its proposed form it may serve to restrict financial institutions from fulfilling their roles of extending credit and providing liquidity.
- ✧ It would be appropriate to cover the NSFR within Pillar 2 as an indicator that supplements the LCR.

Strengthening the resilience of the banking sector

2. Quality of capital

■ Paragraphs 1-59 Overall

Impact on markets and real economy

- ✧ Great care must be taken to avoid an amplification of procyclicality resulting from the introduction of multiple regulations. Even if each regulatory proposal is logical and rational, there are concerns that their cumulative effect may be to generate increased risk of financial system instability. Consequently, consistency among regulations must be ensured and the balance between different regulations must be fully considered.
- ✧ According to the G20, the new regulations “will be phased in as financial conditions improve and economic recovery is assured,” with the aim of implementation by end-2012. At the stage (within 2010) from which regulatory proposals are agreed, serious consideration is required on how regulations will be introduced, including consideration of the reactions of market participants.

Impact on capital markets

- ✧ Depending on what direction is taken on the regulations, there are concerns that various side effects could occur in countries throughout the world, such as needs being generated for banks to raise large amounts of common equity capital on a global basis, leading to a deterioration in the supply-demand balance in the capital markets and a contraction in credit due to risk asset reduction. There are concerns that the capital markets will not be able to absorb all large common equity capital-raising that may be required in response to regulatory changes,¹ and some financial institutions may find it difficult to raise capital by themselves.
- ✧ While it is of course necessary to enhance capital quality, it is also necessary, we believe, to first examine the impact (scale, costs, etc.) of newly designed hybrid debt capital instruments within the capital markets of each country, along with the views of various market participants (issuers, securities underwriters and investors) on such instruments, before making a final decision. As capital procurement by banks is on a larger scale than in other industries and sectors, diverse means of raising capital are necessary, and smooth capital raising contributes to the stability of the financial system.

¹ One piece of research concludes that major European banks will need to newly raise €300 billion in common equity, which is equivalent to 40% of their market capitalization. Source: Nomura International plc report dated December 23, 2009.

Business model diversity

- ✧ In the financial crisis since September 2008, investment banks and others that relied heavily on market financing effectively failed, whereas commercial banks with a strong base of 'sticky' deposits were able to avoid a liquidity crisis. Based on this experience, the new regulations should be even-handed with consideration given to the risk profile of each banking business model.
- ✧ In Japan, which is notable for its stable propensity to save, based on their retail deposits banks typically follow a business model directed at achieving steady growth (although not necessarily high profitability) over the medium to long term. Furthermore, because Japanese banks did have suitable crisis control and risk management structures in place within a macroprudential framework, in the recent financial crisis problems with the shadow banking system were forestalled and the effects on Japan's financial system were limited. A uniform imposition of capital and other restrictions without any consideration of business model diversity could have a highly negative impact on the Japanese economy. In Japan, because most financing is indirect, the impact of such restrictions would be correspondingly greater.
- ✧ We believe that considerations should be made so that the Pillar 2 process, a framework for accommodating diversity across countries, works as intended. We also hope for substantive fairness based on an approach that fully considers the differing organizational structures and legal environments of differing financial institutions.

Regulatory framework

- ✧ Although introduction of across-the-board global regulations is desirable, as business models, financial structures and economic situations differ from one country to another, we must give full consideration to the methods and timing of introduction of new standards, based on the awareness that economic recovery will not be globally even or uniform and that each country's economic circumstances differ.
- ✧ As accounting standards, tax systems, and so forth, differ from one country to another, it is important to maintain a level playing field by developing the regulatory framework based on awareness of these differences. For instance, for regulatory adjustments such as intangibles, deferred tax assets and defined benefit pensions, taking into consideration differences between the legal systems and financial practices in each country should be acceptable and can be expected to enable the development of more effective and balanced regulations.

Importance of having a range of regulatory measures

- ✧ A regulatory framework for ensuring the stability of the financial system should not depend excessively on common equity capital. Instead, systemic risk in finance should be avoided by using a range of regulatory measures, such as macroprudential policy, a prompt corrective action system, a resolution mechanism for financial institutions, and a deposit insurance system.
- ✧ From the perspective of macroprudence, it is possible to develop preventive policy measures by

analyzing trends in the economy and financial system and potential risks before a crisis emerges. A prompt corrective action system enables the regulators to issue a business improvement order before an individual bank collapses, triggered by, for example, a bank's capital ratio falling below the minimum level. These preventive measures should be effectively used alongside equity capital regulations.

- ✧ Furthermore, it is particularly important to have a resolution mechanism for financial institutions and a deposit insurance system as ex-post-facto systems for after a financial institution collapses. If the regulatory authorities can control systemic risk by using a combination of numerous regulatory measures, losses can be absorbed not only by common equity but also by other forms of capital. That is, if systemic risk can be effectively controlled, it will be possible to wind down individual banks and excessive capital levels will not be necessary. The major countries should first develop a resolution mechanism for financial institutions, through a coordinated global approach.
- ✧ In Japan's 'lost decade' in the 1990s, public funds were injected into large Japanese banks across the board, and after that the regulators focused not on requiring excessive levels of capital but on strengthening banks' abilities to capture the risks of their assets. In addition to this, deposit insurance safety nets were enhanced, and disposal of non-performing assets based on strict assessments was accelerated. The market selected which banks could survive under a system of multiple regulatory requirements, not just a capital requirement, and indeed many banks were absorbed into larger entities.

Appropriate consultation procedures

- ✧ In the consultative documents, the thinking behind the regulations is merely presented, and there are several parts that are unclear. Therefore, we would like there to be another round of public comments after the details of the proposed regulations are finalized based on the results of the latest QIS.

■ Paragraphs 46-49 Liquidity surcharge, capital surcharge

- ✧ A capital surcharge and a liquidity surcharge should not be levied on systemically important financial institutions (the major financial institutions), as these would reduce the effectiveness of the financial system and invite unfairness and so forth in the competitive environment.
- ✧ As methods of minimizing the impact of systemic risk arising from the size of financial institutions, ex-ante preventive measures should be extensively established. These should include inspections by the regulators and the establishment of a prompt corrective action system. Ex-post-facto measures, such as a deposit insurance system and a resolution mechanism for financial institutions, should also be solidly established.

■ Paragraphs 10, 59, 64, 84 Grandfathering

- ✧ Grandfathering, in essence, should be for a period that starts from when regulations have been finalized and lasts until a set date after that, so it is not appropriate to have grandfathering up to December 17, 2009, the date when the consultative document was released. The grandfathering period during which new instruments can still be issued under the existing standards should be the period until the new regulations are implemented.

■ Paragraphs 68, 85 Limits and minima

- ✧ If, as indicated in the consultative documents, the loss-absorption capacity of Tier 1 additional going concern capital is raised, in order to raise its loss absorption capacity to a similar level to common equity, there should be no need for a numerical standard for the predominant ratio (x/y) and it will be important to establish both the x and y ratios. Furthermore, the exclusion from Tier 1 capital of a part of Tier 1 additional going concern capital through the predominance rule contradicts the aim of strengthening Tier 1 capital.
- ✧ If, by introducing new regulations, the quality of banks' capital is improved and the capability to capture risk is strengthened compared to that under the existing regulations, a bank's capital level under the new regulations would, by definition, imply higher quality capital than the same capital level under the existing regulations, so there should be no need to raise the minimum capital ratios.
- ✧ Decisions on the various ratios of x, y and z should only be made after careful consideration of the effects on particular banks and the establishment of a fully adequate transition period, as well as consideration of matters such as the expected reactions of the market and market participants such as investors.

■ Paragraphs 87-89 Loss absorption

- ✧ We presume that behind the view that the loss absorbency of Tier 1 and Tier 2 capital must be improved are perceptions that during the recent financial crisis, among banks which effectively became gone concerns and had to rely on injections of public funds, hybrid Tier 1 and Tier 2 regulatory capital did not absorb losses or bear its fair share of the burden.
- ✧ Before considering this issue, however, we believe it necessary to improve systems for dealing with bank failures and clarifying shareholders' responsibilities. In Europe and the United States, there were some banks that received public funds without any reduction in common equity. In Japan, while Article 102 of the Deposit Insurance Law does allow for the injection of public funds during a financial crisis, Article 106 of the same law delineates a framework by which banks can be required to take capital reductions. Indeed, with regard to the Long-Term Credit Bank of Japan and the Nippon Credit Bank, a 100% capital reduction was implemented.

■ Paragraphs 67-68, 75-77, 89 Tier 1

Preferred stock

- ✧ Preferred stock, which is classified as shareholders' equity in Japan, has the required loss absorbency characteristics of Tier 1 additional going concern capital. The issuer of preferred stock has the discretion to suspend dividend payments, and the dividends are non-cumulative, and regardless of any conversion clause, half the issued amount of preferred stock can be included within capital and the remaining half within capital reserves. Upon an ordinary resolution of the general meeting of shareholders, the portion included in capital reserves can be used to absorb losses.

Tier 1 additional going concern capital criteria: Call options (Paragraph 89 (5))

- ✧ Call options are essential for the maintenance of flexibility in the capital policy of individual banks.
- ✧ Call options do not cause a deterioration of capital quality, and those that have been granted are not necessarily redeemed. There have been many cases where call options have not been exercised, but market expectations of their redemption have not increased. Furthermore, the approval of the regulator is required prior to the exercise of call options and it is clearly established that banks need to either demonstrate that they can maintain an adequate level of capital or refinance at the same or a higher-quality level.

Tier 1 additional going concern capital criteria: Definition of bankruptcy (Paragraph 89 (10))

- ✧ The requirements for bankruptcy differ according to the bankruptcy law of each country. In Japan, for example, application for bankruptcy proceedings can be made in accordance with either a balance sheet test (excessive debt) or a payment obligation test (inability to meet payments). However, we understand that in certain other countries the only valid requirement is the inability to meet payments. In such countries, no Tier 1 hybrid capital would be excluded from the calculation of Tier 1 under the criteria of Paragraph 89(10). We understand that the purpose of Paragraph 89(10) is to inhibit the inclusion in Tier 1 of large amounts of Tier 1 hybrid capital that is not included in shareholders' equity. Therefore, in countries where only the inability to meet payments is allowed as a requirement for bankruptcy, the restraining function of Paragraph 89(10) is inoperative and the proposed regulation does not achieve its objective.
- ✧ Assuming that it is not realistic to achieve international harmonization of bankruptcy law in a short period of time, in economic terms the same debt-type capital instruments with the same loss absorbency characteristics will be included in Tier 1 in some countries and excluded in others due to differing national bankruptcy regulations. This would clearly be extremely unfair and contravene the aim stated within the Basel regulations of preserving a level playing field, and thus Paragraph 89(10) is not necessary.

Reference: Hybrid Tier 1 markets**Overall global market**

- ✧ Currently the overall hybrid Tier 1 securities market is estimated at around US\$285 billion. The largest issuers are European banks who account for around 55% of the total issued amount (see Figure 1).

Japanese market

- ✧ At present, the balance of preferred securities issued by Japanese banks amounts to around US\$64 billion. Among them, yen-denominated preferred securities account for around US\$46 billion, or 76% of the total amount.

Figure 1: Hybrid Tier1 issuance market (by region, currency; as of end Jan. 2010)

	USD-denominated (USD bn)	EUR-denominated (EUR bn)	GBP-denominated (GBP bn)	JPY-denominated (JPY 100 bn)	Total (USD bn)	
North American banks	54.0	1.3	2.1	0.0	56.3	19.8%
European banks	65.7	103.8	24.8	0.0	156.4	54.9%
Japanese banks	11.0	1.8	1.3	45.7	63.9	22.4%
Asian banks excl. Japan	7.3	1.0	0.2	0.0	8.2	2.9%
Total (USD bn)	138.0	77.6	18.3	50.8	284.7	100.0%

(Source: Compiled by MUFG based on data by Bloomberg and others)

■ Paragraphs 78, 90, 91 Tier 2**Roles of Tier 2 capital**

- ✧ The roles of Tier 1 (going concern) capital and Tier 2 (gone concern) capital should be clearly distinguished. Tier 2 capital continues to serve an important role as a source of funds to protect creditors, especially deposit holders, upon a bank failure. It is important to have an arrangement under which Tier 2 capital absorbs losses when a bank fails.

Straight-line amortization

- ✧ There is no need to 'amortize' recognition of Tier 2 capital in regulatory capital over the relatively long period of five years in order to ensure that it has loss absorbency upon bankruptcy. Based on the concept of Tier 2 capital being gone concern capital, we consider this unnecessary. In accounting theory, the period for considering whether a company is a going concern is one year following the end of the fiscal year in question, so from that perspective amortization over a five-year period is too long and lacks rationality.

Tier 2 criteria: Step-up interest, call period (Paragraph 90 (4), (5))

- ✧ Tier 2 securities with step-ups should continue to be accepted. The debate on abolishing step-ups that stems from concerns relating to the probability of call options being exercised should distinguish between Tier 1 capital required for loss absorption on a going concern basis and Tier 2

capital required for loss absorption on a gone concern basis. As recommended in the consultative document, instruments with maturities are included in Tier 2 capital and a fundamental premise of such instruments is that they will be redeemed. With that in mind, instruments with call incentives in the form of step-ups should be considered as falling under the category of Tier 2 instruments that are designed to be redeemed.

- ✧ Given such factors as the function of Tier 2 capital as gone concern capital, the fact that it includes instruments with maturities, and the need to obtain prior supervisory approval to exercise a call option, there should be no minimum call period before a call option can be exercised.
- ✧ From the perspective of maintaining and maximizing the diversity of capital financing, it is necessary to maintain a diverse range of instruments that meet the needs of various investors, within the scope of maintaining the functions of Tier 2 capital. Instruments with step-up interest and particularly instruments for which the minimum period before a call option can be exercised is less than five years (subordinated bonds for retail investors issued by Japanese banks all have three-year call options, and the market size of such bonds is around US\$20 billion or ¥2 trillion yen) should continue to be accepted as Tier 2 capital under the new regulations.

Reference: Tier 2 market

- ✧ The Japanese Tier 2 securities market mainly consists of callable subordinated bonds with step-ups (in fiscal 2009, around 68% of the total amount of Tier 2 financing in the Japanese public markets consisted of callable bonds with step-ups. See Figure 2). The annual size of this market is ¥500 billion (including privately placed bonds the figure is even greater), and as evident in Figure 3, the types of investors who invest in bullet bonds and callable bonds are clearly different. The issuers have been striving to ensure that stable capital financing is possible and to maximize the size of capital financing.

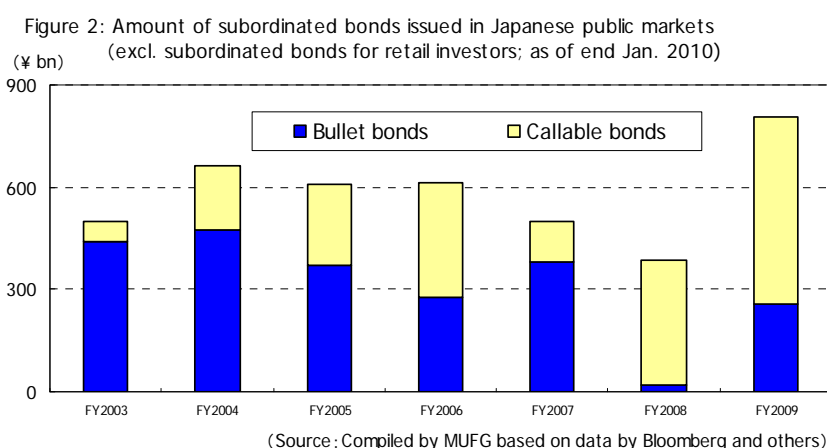


Figure 3: Japanese Tier2 market by type of investor

Instrument	Typical example	Main Investor
Bullet bond	10-year bullet	Insurance, Pension funds
Step-up callable bond	10NC5(Step-up)	Regional banks
Non-step-up callable bond	8NC3(Non-step-up)	Retail investors

(Source: Compiled by MUFG)

■ Paragraph 91 Contingent capital

Tier 1 additional going concern capital: Role and method of introduction of contingent capital

- ✧ In terms of the design of capital instruments, mandatory conversion or write-down features have the advantage of increasing the loss absorbency of hybrid debt capital, and may be said to be an effective means of sourcing capital buffers. On the other hand, from the perspective of ensuring stable capital financing, the needs and views of investors, who provide the capital, need to be fully considered. Specifically, in order to determine if a stable capital market of sufficient size can be established for contingent capital, it is appropriate to establish a certain test period.
- ✧ At present, the investors that purchase hybrid Tier 1 securities are mostly fixed-income investors, but if mandatory conversion and write-down features are added as requirements for hybrid Tier 1 securities, there is a possibility that many of these fixed income investors will no longer be able to purchase such securities. Actually, major Japanese life insurance companies, which comprise the majority of investors in yen-denominated preferred securities, have indicated as an initial reaction that it would be difficult for them to invest in hybrid Tier 1 securities if they had requirements to serve as Contingent Capital and thus became more like equity in nature.
- ✧ Furthermore, in terms of capital structure, if the cost of procuring contingent capital is not lower than that of procuring common equity, the issuing party would have no incentive to take that route (procurement structure hierarchy issues). That said, at the present time, a consensus on this has not been formed, and there is considerable uncertainty, so it is unclear whether a desirable hierarchy will emerge. Accordingly, decisions on whether to introduce contingent capital instruments and how to design them should be made only after sufficient and careful consideration of the preferences and capacity of the market.

Tier 1 additional going concern capital: Instrument design for contingent capital

We believe that contingent capital must have the following characteristics.

- ✧ Trigger point
 - Investors would presumably prefer that the trigger be:
 - simple
 - transparent

- easy to monitor
 - specific to bank risks
 - not subject to regulatory changes
- Based on the above, we consider a capital adequacy ratio to be a desirable candidate for a trigger, especially a common equity ratio or a simple and highly transparent shareholders' equity ratio (shareholders' equity divided by risk-weighted assets).
- ✧ Write-down features
- The write-down mechanism (to allocate losses to the instruments) should be based on the presumption that, should bank earnings recover, there may also be write-ups (it would be harsh on investors to only recognise write-downs). Also, instrument design must reflect a consideration of the tax, accounting and legal frameworks of each country.
- In order to increase the freedom of choice of products, it is desirable that there should be a choice between mandatory conversion and a write-down clause
- ✧ Pricing
- Pricing would depend on the trigger level. To keep procurement costs down, the trigger must be set at a level corresponding to a sufficiently low probability of being hit.
- ✧ Conversion price
- The conversion price should be set at the time of issuance (i.e. be presettable). Revisable (i.e. resettable) conversion prices run the risk of a death spiral.
- ✧ Period
- The instrument must have a maximum period of 10 years. It is difficult for investors to accept perpetuity for such instruments. As it is also difficult to assess the probability of the trigger being hit, a shorter period is desirable (preferably about 3 years). From the perspective of procurement costs (capital efficiency), the instrument should not be amortized.
- ✧ Adjustments for regulatory changes
- Instrument design needs to be adjusted for regulatory changes. As one example, the design should be such that upon the adoption of new regulations, the instrument continues to comply with the old regulations or should be granted an option for redemption at that time.
- ✧ Ratings
- It would be easier for fixed income investors to invest in an instrument with a rating.
- As there are still very few examples, it is unclear what ratings would be assigned to contingent capital. Assuming a product could receive a BBB rating, there would probably be a fairly broad range of interest in it.
- ✧ Tax treatment of interest payments
- The payment of interest on contingent capital should be tax deductible.

Tier 2: Mandatory conversion and write-down features

- ✧ As noted in paragraph 90, the purpose of Tier 2 capital is to absorb losses in the event of bankruptcy, while prior to bankruptcy it is not required to absorb losses. Consequently, we believe that instruments with mandatory conversion or write-down features should be recognised as Tier 1 or its capital buffer on a going concern basis.
- ✧ However, if mandatory convertibility or write-down features are to be seen as conditions for inclusion in Tier 2 capital, the conditions for setting the trigger point should differ from those of additional Tier 1 going concern capital and the role of Tier 2 capital on a gone concern basis should be clarified. Furthermore, in such cases the precedence among the different forms of regulatory capital in sharing the burden of losses must be clearly established and the associated regulatory conditions precisely specified.
- ✧ More specifically, when a bank enters legal bankruptcy, Tier 2 capital will be converted to common equity or written down through loss absorption. However, problems will arise with these mandatory conversion or write-down features in cases where the bank is actually a gone concern but continues to exist. Therefore, it may be appropriate to consider setting the trigger point for such features at a stage within the mechanism of resolution procedures. In the case of Japan, for example, we believe that it would be appropriate to set this trigger point at the stage when insolvent financial institutions are treated under Article 102 Paragraph 1 Item 2 (the “Item 2 measure”) and Item 3 (the “Item 3 measure”) of Japan’s Deposit Insurance Act. It is not appropriate to set this trigger point at the stage when preventive actions to reinforce capital are taken.

■ Paragraph 93 Regulatory adjustments

- ✧ The consultative document sets out proposed regulatory adjustments to be applied to regulatory capital, such as minority interests, deferred tax assets, intangibles, investments in other financial entities, and defined benefit pension assets. It is necessary to consider whether these regulatory adjustments, taken as a whole, will exacerbate procyclicality in times of economic downturns.
- ✧ The proposal is that the regulatory adjustments will all apply to common equity, but given that loss absorbency problems may arise at times of financial troubles or bankruptcy, we believe that it is more appropriate that some regulatory adjustments apply to common equity, some to Tier 1 additional going concern capital (goodwill, deferred tax assets, etc.), and some to Tier 2 capital (defined benefit pension plans, etc.).

■ Paragraph 95 Regulatory adjustments (minority interests)

- ✧ Minority interests can serve as loss absorption buffers for the risk assets of the relevant subsidiaries, and so should be included in common equity.
- ✧ Supposing that minority interests are not included in common equity, if the related risk assets are

not deducted from the denominator, it would be an unnecessarily conservative and unbalanced approach.

- ✧ The options here are either to continue with the existing standard or partially deduct from the denominator a portion of the risk assets of the relevant subsidiary equivalent to the size of the minority interests. So, if the amount of minority interests to be deducted is, for example, 30%, 30% of the relevant subsidiaries' risk assets should be deducted.
- ✧ Regarding overseas investments, some countries (particularly emerging market economies) have regulations governing foreign capital that make it difficult to enter the market with a wholly owned subsidiary (joint ventures and so forth are a commonly used form of entry). If minority interests cannot be included in common equity, it may make it difficult to invest in these markets.

■ Paragraphs 85, 96 Other comprehensive income

- ✧ The consultative document states that other comprehensive income should be added to common equity, but says that treatment of unrealized gains is a matter for future consideration. There should be no inconsistencies in the treatment of unrealized gains and unrealized losses.

■ Paragraph 97 Regulatory adjustments (other intangibles - software)

- ✧ The consultative document proposes that goodwill and other intangible fixed assets should be deducted from the common equity component of Tier 1. This is based on the idea that intangibles cannot be converted into cash, but the fact is that some tangible fixed assets cannot be converted into cash either. Most of a bank's assets are financial assets, but on the other hand, it is the combination of a range of the bank's assets that generates business cash flows. Accordingly, when making decisions on regulatory adjustments for intangibles, instead of focusing only on whether the assets are convertible into cash, we should add another factor for making decisions: whether the assets are important ones that generate business cash flows.
- ✧ Software, along with hardware, is a key part of banks' systems. It is an essential component for generating cash flows in core businesses such as the settlement business, and therefore should not be deducted from the common equity component of Tier 1. Doing so could create a major obstacle to banks' systems development, both in terms of the systems development of individual banks and the evolution of the systems of the banking sector as a whole.
- ✧ In Japan software is recorded as an intangible asset, while in the U.S. and Europe it is usually recorded as a tangible asset together with hardware. This differing treatment is the result of differences between both the accounting standards and systems development methods for software assets in different countries, and is not related to whether the assets are easily convertible to cash or not. Therefore, testing whether such assets are easily convertible to cash or not only where they are recorded as intangible assets presents problems from the perspective

of fairness (i.e. maintaining a level playing field).

- ✧ In Japan, accounting systems are mainly developed in-house and recorded under intangible assets as software. However, at U.S. and European banks software is usually purchased from an external party and recorded as a tangible asset. To completely remove intangible assets from common equity without sufficient examination of differences in accounting standards and business practices is logically inconsistent. Deliberations about regulatory adjustments should include careful examination of the differences in the actual characteristics of assets and accounting standards in each country. Focusing solely on accounting items and making across-the-board eliminations is not appropriate.

■ Paragraphs 98, 99 Regulatory adjustments (deferred tax assets)

- ✧ Deferred tax assets (DTAs) are an item that, to a considerable degree, reflects differences between book value and tax value under local accounting standards and local tax law. In the U.S. and Japan, as substantial differences arise between accounting standards and tax systems, the amount of DTAs tends to be large. In Europe, however, the differences between accounting standards and tax systems are small (since tax standards are as a general principle in accordance with corporate accounting standards), so the amount of DTAs tends to be comparatively small.
- ✧ Furthermore, the amount of DTAs is assessed by an audit conducted by external auditors in a conservative manner based on the going concern assumption, as an amount of DTAs with a reasonable probability of realization. Therefore, the characteristics of DTAs as assets are supported by accounting standards and by an audit and those DTAs that do not have the characteristics of assets should already have been excluded from valuation reserves.
- ✧ Accordingly, the exclusion of all DTAs from capital will result in inconsistencies arising due to the differences in accounting standards and tax systems between countries and will result in a loss of comparability.
- ✧ Therefore, from the perspective of maintaining international comparability, the full amount of DTAs should be recognised. If the Committee seeks to make the new regulations even more conservative than accounting standards, then it would be appropriate to use a method that recognises DTAs up to 20% of either Tier 1 capital or common equity (common stockholders' equity + retained earnings) before deduction of regulatory adjustments. Furthermore, limits on the inclusion of DTAs based on future taxable income present difficulties from the perspective of maintaining a level playing field, due to differences in national tax systems.
- ✧ Moreover, because DTAs increase according to the degree of conservatism practiced in provisioning, the complete exclusion of DTAs would result in a regulatory contradiction in which the more prudent the bank, the greater the penalty would be. This is a further reason why it is inappropriate to completely exclude DTAs.

■ Paragraph 100 Regulatory adjustments (investments in own shares - treasury stock)

- ✧ A bank's own shares included in index securities are not held intentionally, and account for only a small fraction of the entire portfolio. Requiring the complete deduction of a bank's exposures to its own shares from index securities would create a situation in which the costs of doing so would outweigh the effectiveness of the regulations. Such a deduction should therefore not be required.
- ✧ Determining the index securities held by consolidated subsidiaries and deducting the bank's own shares from them also would create a substantial administrative burden despite the extremely insignificant effect of this item, and it is therefore not practical.
- ✧ Furthermore, the complete deduction of treasury stock included in an index would depress trade in index securities (in particular, their purchase), which could present an obstacle to thorough risk management by banks that use index securities and lead to a reduction in market liquidity.

■ Paragraph 101 Regulatory adjustments (double gearing)

- ✧ The definitions of the scope of financial institutions to be excluded and of reciprocal cross holding agreements differ according to the legal systems of different countries, therefore great care must be exercised.
- ✧ If double gearing is applied broadly to investment in financial institutions it will present an obstacle to sound incentives for financial institutions to expand their business through capital alliances. We thus believe that investment in overseas financial institutions should be excluded from the regulatory adjustments. For example, in Asia, where many governments limit the stake that a foreign bank can take in a domestically owned financial institution (upper limit on stake by a single foreign company: China, 20%; India, 5%; Vietnam, 15-20%; Malaysia, 15%; Thailand, 49%), it would become difficult to arrange minority investments within that region, which could damage customer convenience and the development and smooth operation of finance.
- ✧ The method of adoption of double gearing regulations should be carefully examined both in terms of the lessons of the recent financial crisis and theoretical consistency, based on substantive analysis of the long-term implications for the capital financing structure of financial institutions in each country. The recent financial crisis has not led to the bankruptcy of a single Japanese bank, and interconnectedness differs to a certain extent by country and by currency.
- ✧ Investments that straddle multiple countries or regions (among which the knock-on effects of a bankruptcy would to a certain extent be divided) can vitalize global money flows in normal times, while such investments can contribute to stabilization of the financial system in times of crisis. Actually, in the recent financial crisis, before the injections of public funds by governments in the United States and Europe, funds from oil-rich states in the Middle East and investments by major Japanese financial institutions, among others, contributed to stabilization of the financial system in the United States and Europe. Negative effects on this type of investment resulting from subsequent changes in capital regulations should be avoided, and even if the proposed

regulations on investment in overseas financial institutions are introduced, grandfathering should be allowed.

- ✧ The deduction of investments in financial institutions that are recorded on the trading book would considerably reduce the risk-taking capabilities of group securities companies in operations such as equity underwriting and would impair the sound functioning of the market. Furthermore, the procedure for including the trading book in the calculation of the balance involves an extremely complicated accounting process, which would create a considerable burden and is therefore not practical.
- ✧ Investment in index securities is made with the objective of hedging risk taking in the overall equities market and on the investment portfolio; it does not constitute investment in specific banks. Therefore, double gearing should be limited to intentional holdings as defined by Japanese financial regulatory rules, and it is not appropriate to include trading books and index securities within the scope of double gearing.

■ Paragraphs 102, 103 Regulatory adjustments (excess expected losses)

- ✧ The incentive for banks to provision at low levels for expected losses would be removed, as any shortfall would be deducted from the common equity component of Tier 1 capital.
- ✧ To ensure sufficient incentive for provisioning, the existing cap on the inclusion of provisions (1.25% and 0.6% of credit risk-weighted assets under the standardized and IRB approaches, respectively) should be removed.
- ✧ Expected losses and provisions are both, in essence, projected future losses. As such, we believe a framework should be established to ensure conceptual consistency between accounting standards and banking regulations.

■ Paragraphs 106, 107 Regulatory adjustments (defined benefit pension fund assets)

- ✧ Given that pension systems and their accounting standards differ by country and region, these differences should be fully considered. However, any accounting differences would likely be eliminated if Japanese financial institutions were required to adopt IFRS. Furthermore, as one element of convergence of Japanese accounting standards, a treatment by which the full amount of any pension underfunding would be booked as a liability is currently under consideration. Thus, in our view, from the perspective of enabling international comparison, defined benefit pension fund assets should be removed from the list of regulatory adjustments until IFRS becomes mandatory or convergence is completed.
- ✧ Prepaid pension expenses are booked to the extent that the market value of pension assets or the amount of unrecognised actuarial differences exceeds the projected benefit obligation (PBO). We believe that if prepaid pension expenses are included as a regulatory adjustment, banks should

be able to exclude from the adjustment, at the very least, the portion pertaining to the excess of pension asset market value over PBO.

- ✧ Furthermore, the loss absorbency of defined benefit pension fund assets should be looked at from the perspective of bankruptcy (i.e. on a gone concern basis), as such pension funds assets will only stop functioning as assets when the company becomes a gone concern. Consequently, if defined benefit pension fund assets are to be applied as a regulatory adjustment, they should be applied to Tier 2 capital.

■ Paragraph 109 Disclosure requirements

- ✧ Providing full and detailed disclosure of elements of regulatory capital would present some difficulties from the perspective of investors, vis-à-vis private placements and so forth. Our position is that the disclosure of certain elements of regulatory capital based on materiality is more appropriate than detailed disclosure of all elements.

3. Risk capture

■ Paragraphs 123-125 Measuring counterparty credit risk using bond-equivalent capital add-on approach

While we understand the reasoning behind the proposal for an additional capital charge for mark-to-market losses (i.e. credit valuation adjustment (CVA) risk) associated with deterioration in the creditworthiness of a counterparty, we see many conceptual and practical issues related to calculating the charge. Below we outline some major points and present an alternative proposal for further consideration.

- ✧ Issues related to types of transactions subject to CVA risk capital charge
 - OTC derivatives have two main purposes. The first pertains to their utilization as hedges (interest rate ALM, export/import-related forex hedging, etc.) in conjunction with the ordinary transactions of a corporate client (we call this “real demand”). The second is for active risk taking. In the latter case, the derivative contracts are typically closed or hedged during the contract period, so they do present a risk of a change in market value. As such, we understand why they would come under the current proposal. In the former case, however, the contracts basically remain in effect until they reach maturity—that is, in principle, they are not closed during the contract period. Thus, one could say that they are similar to held-to-maturity securities, whose changes in market value during the holding period do not apply. For this case, we think that the current default risk measurement method is sufficient.
 - One of the core businesses of commercial banks is to meet the hedging needs that arise from real demand from business corporations. We think the proposal goes too far by calling for an additional capital charge without distinguishing this type of “real demand” transaction from speculative derivative transactions. Consequently, we believe that the proposals in the consultative document would have an unfair impact on commercial banks, which tend to deal with a large number of corporate clients. We strongly suggest that transactions arising from the real demand of corporate clients should not be subject to the proposed CVA risk capital charge.
 - If we look at the timing and propagation of the surge in counterparty credit risk, one of the causes of the financial crisis, we can see that a deterioration in credit risk at some financial institutions spread to other financial institutions in a rapid and interconnected manner through the financial system. We can thus understand why financial institutions should be included within the scope of this regulatory initiative. On the other hand, with regards to transactions arising from the real demand of corporate clients, it is hard to imagine that counterparty credit risk would spread in an interconnected manner to other business corporations. Furthermore, the scale of transactions arising from real demand should be within the business capacity of the corporate clients, while any changes in the credit quality of such companies are fully monitored using internal rating systems. Throughout this crisis, there has been no change

whatsoever in how the risks presented by business corporations are perceived. For this reason as well, we believe that transactions arising from real demand from corporate clients should be excluded from the scope of this proposal.

✧ Problems with measurement methods

- The Committee proposes to measure the risk of a change in market value of OTC derivatives recorded in the trading book from three angles: general market risk due to changes in the risk-free rate; specific risk due to changes in the spread of the issuer; and CVA risk due to changes in the spread of the counterparty. Despite this, the holding period for general market risk and specific risk is 10 days, and that for CVA risk is one year. This is not consistent.
- Although CVA risk measures the change in market value due to changes in the creditworthiness of the counterparty, the proposed “bond-equivalent of counterparty exposure” approach measures not only the specific risk associated with the issuer, or counterparty, but also the general market risk. As this is a form of double counting, it is not consistent with the proposed regulatory framework.
- The Committee’s proposal uses the CDS spread as the discount rate for determining the bond equivalent. Because CDS spreads are highly volatile, we consider this to be inappropriate.
- In measuring market risk, banks that use the standardized measurement method to calculate specific risks would be required to declare all specific risk including default risk, while those that use IMM would be able to exclude default risk. We do not think that this is fair.
- Moreover, it is unclear how the current proposal relates to a separate initiative being advanced toward a fundamental review of market risk calculation. We fear that this lack of coordination will impose an unnecessary burden on private-sector financial institutions.

✧ Alternative proposal

- In consideration of (1) the insufficient degree of study with regards to the suitability of the proposed market risk-based measurement method and (2) the issue of consistency with the initiative to fundamentally review the approach to the calculation of market risk, we propose that this initiative (i.e. calculation of a CVA proxy with a market risk method) be postponed until the fundamental review. In the meantime, the following approach can be used within the existing framework for measuring counterparty credit risk. From the aspect of minimizing the personnel and non-personnel cost burden, we believe that this approach has merits in comparison to the proposal contained in the consultative document.
 - ✓ If handled within the credit risk measurement framework, risk assets could be measured by assigning some sort of scaling factor to EAD of counterparty credit risk under the current system.
 - ✓ For the assignment of scaling factors, some simplified method could be devised under which financial institutions (including hedge funds, mutual funds, etc.) could exclude the

impact of transactions with business corporations and other parties that present no financial systemic risk.

- ✓ Scaling factors could be set in such a way that assures fairness—that is, in such a way that a bank is not placed at a disadvantage because of differences in its method of calculating market risk or credit risk (treatment of collateral, etc.).
- Furthermore, should a method of calculation that makes use of a market risk method be introduced ahead of the fundamental review, clear commitments should be made regarding (1) the treatment of that method upon the completion of the review and (2) a consideration of the burden to be borne by private-sector financial institutions.

■ Paragraphs 135-139 Applying a multiplier for the asset value correlations of financial firms

- ✧ With regards to correlation coefficients, we begin by noting the difficulty of deciding upon a uniform method of determining such correlations, which has led to the establishment of a framework within Pillar 2 by which banks set for themselves a correlation coefficient appropriate for their portfolios and demonstrate their capital adequacy. Given this, it is unclear what the grounds would be for a uniform increase in the asset value correlations of financial firms. If indeed it has been demonstrated by the Committee that financial institutions are more correlated than earlier envisioned and have substantially higher systemic risk sensitivity, that information should be disclosed.
- ✧ Total assets are cited as a proxy for systemic risk sensitivity and, as such, are used to distinguish between highly correlated financial firms and other financial firms. However, according to “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations” issued by the IMF/BIS/FSB in October 2009, systemic importance cannot be adequately assessed on a simple numerical basis alone, but also requires a qualitative analysis. Within that guidance, the size of a financial institution is based on the amount of its financial services. Here, simply using total assets would contradict the thinking behind that guidance.
- ✧ It is illogical to categorise correlations by using a single threshold value for commercial banks and brokerage firms, because commercial banks have relatively large balance sheets with loans on their books while brokerage firms have relatively small balance sheets due to not carrying client assets as assets on their books.
- ✧ Furthermore, we are concerned that applying an asset value correlation multiplier would be an excessive response to the financial crisis if regulations covering leverage ratio, liquidity ratios and so forth are also strengthened.
- ✧ We suspect that the higher-than-envisioned risks encountered by systemically important banks during the financial crisis can be attributed to excessively low long-term average PD estimates for large financial institutions and unregulated financial firms, both of which are considered low

default portfolios. Rather than attempting to fine-tune the correlation, which is difficult to validate, we believe it more reasonable to prepare some minimum requirements for internal ratings for financial institutions and PD estimation. This would also accord with the proposed “treatment of highly leveraged counterparties.” If the borrower classification and PD estimation practices of financial institutions are made more rigorous, then their risk weightings should rise accordingly.

■ **Paragraph 164 Regarding treatment of highly leveraged counterparties**

- ✧ The consultative document states that “estimates for counterparties that are highly leveraged or for counterparties whose assets are predominantly traded assets should reflect the performance of the counterparty’s assets based on periods of stressed volatilities.” However, it is impossible to come up with a statistically significant estimate of PD for a highly leveraged counterparty portfolio alone. If supervisors intend to raise the risk weights for specific counterparties, this should be done by assigning lower ratings on a specific company basis rather than using the proposed PD estimates reflecting the period of stressed volatilities.

4. Leverage ratio

■ Paragraphs 202-207 Regarding the positioning of leverage ratio regulations

- ✧ As there is a paradoxical effect with liquidity regulations, and in the current situation where the overall financial balance sheet structure of each country differs, it is not appropriate to give the proposed new leverage ratio Pillar 1 treatment as an internationally harmonized standard. It should be given Pillar 2 treatment instead. That is, the leverage ratio should be used as a mechanism under which a bank is required to explain or report to its national supervisor if its leverage ratio exceeds a certain level, or in other words, as part of the monitoring tools available to national supervisors.
- There is a lack of consistency with liquidity regulations that encourage holding of highly liquid assets such as government bonds
- Leverage ratios differ greatly from one country to another, as they are swayed considerably by differences in different countries' accounting standards, capital markets, and balance sheet characteristics.

■ Paragraph 208 High-quality capital

- ✧ The numerator, should not be limited to common equity, but should be Tier 1 capital, or capital.
- The purpose of leverage ratio regulations is to prevent excessive leverage, including off-balance sheet items, during upswings in the economic cycle, and to use a simplified indicator that includes off balance sheet items for the same purpose. Moreover if the simplified indicator for the denominator includes a wide range of assets, the numerator should include a wide range of types of capital without fine distinction between types.
- If common equity is used as the numerator and a corresponding leverage ratio is established, compared to a situation in which capital or Tier 1 capital is used as the numerator, a unit increase in the numerator allows greater room for an increase in assets, and carries the danger of encouraging excessive leverage and runs counter to the purpose of the regulations. Therefore we believe that the numerator should be Tier 1 capital, or capital.

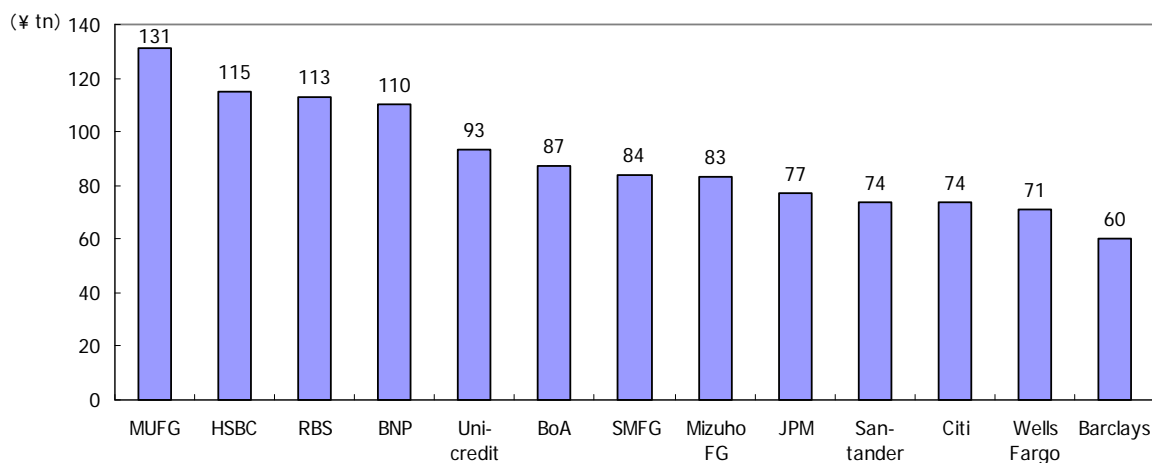
■ Paragraphs 212-216 Accounting measure of exposure; netting

- ✧ As the leverage ratio is designed for a simplified indicator without taking into account the risk levels of exposures, we agree with the Basel proposal that exposures should be measured on a gross basis in principle.

■ Paragraph 219 High-quality (low-risk) liquid assets

- ✧ One reason given for introducing a leverage ratio is that it would help to avert an unstable deleveraging process that could have a damaging impact on the broad financial system and overall economy. It is hard to envision that high-quality liquid assets, which can be sold or used as collateral to procure funds even in times of stress, would act to damage the financial system through such unstable deleveraging.
- ✧ Thus, as shown within the additional options of the QIS, high-quality liquid assets (cash, deposits with the central bank, government bonds, etc.) should be excluded from the denominator. If they are not excluded, this would run contrary to the proposed liquidity regulations, which seek to promote the holding of low-risk liquid assets, impede banks' financial intermediary function of transferring excess savings from the private sector to the public sector, and otherwise adversely affect the financial system and overall economy.
- Japanese banks have high levels of deposits, or structurally speaking, excess deposits (see Figures 4 and 5). Furthermore, the bulk of Japanese government bonds are sold to domestic financial institutions, with only 6.4% sold to foreign investors (as of the end of March 2009). This contributes to interest rate stability. It is because of this structure that the proportion of government bonds to total assets is also high (see Figure 6).

Figure 4: Deposit balance



(Source : Bank disclosure as of end of June and end of September 2009)

Figure 5: Excess deposits and deposit-lending ratios

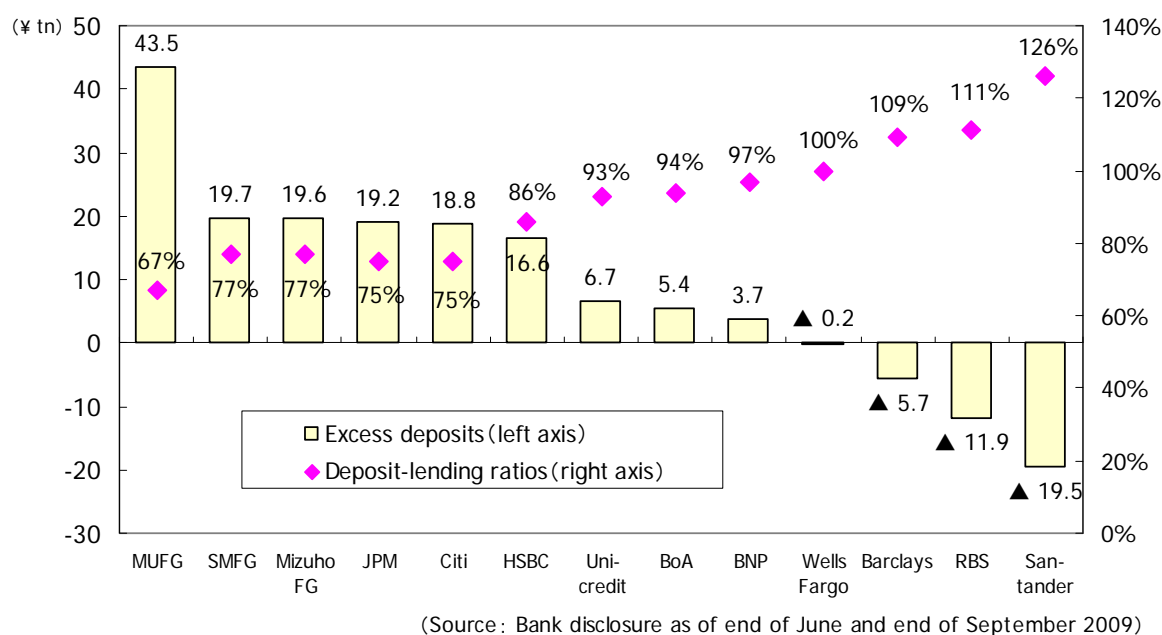
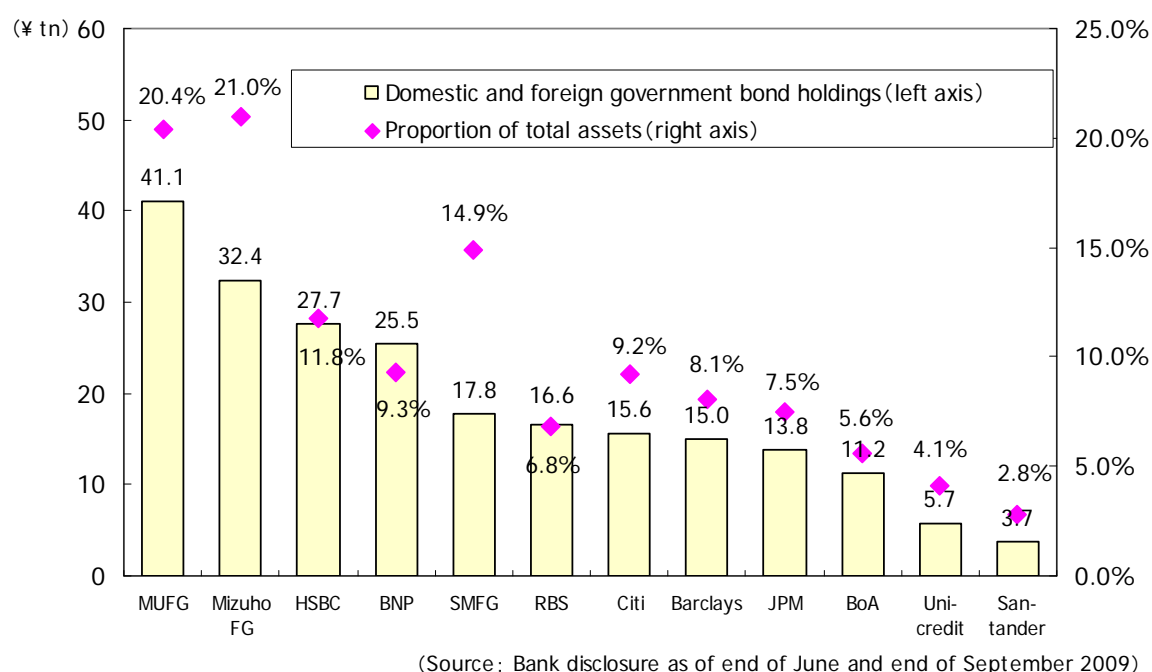


Figure 6: Domestic and foreign government bond holdings, proportion of total assets



■ Paragraph 220-229 Repurchase agreements, securities finance, securitization and derivatives

- ✧ As stated in the consultative document, in order to achieve the objectives of leverage ratio regulations, the gross amounts in the accounts should be used in respect of repurchase agreements, securities finance and securitization exposures, and for derivative transactions. Using gross amounts accords with the aim of identifying a simple indicator.

■ Paragraphs 230-231 Credit derivatives

- ✧ As the effect of a written credit derivative position is similar to a potential on-balance sheet credit, a 100% credit conversion factor (CCF) should be applied. From the viewpoint of the objective of the leverage ratio regulations there should be no netting with long positions.

■ Paragraph 233 Off-balance sheet items

- ✧ Because off-balance sheet items are indeed a source of potentially significant leverage, we agree with the idea of including them within the denominator. However, with regards to the credit conversion factor, we advocate its use under the standard method of the Basel 2 framework as shown within the additional QIS options.
 - It would carry the risk of hindering banks in fulfilling some of their intermediary functions, such as the provision of commitment lines and flexible liquidity to customers.
 - Regarding the amounts of unused commitment lines, exposure should be calculated according to the CCF recognised by the Basel regulations. Furthermore, as in the Basel 2 regulations, the calculation should be made using risk-sensitive weightings rather than simple balances.

■ Paragraph 236 Disclosure

- ✧ With regards to disclosure, we believe that the arrangement should be such that the bank may simply explain the appropriateness of its leverage ratio level, in which case it would be appropriate for that bank to describe its method of calculation, internal control systems and so forth.
 - Business portfolio models can vary from one country to another and even within one country, as can risk management capabilities. Thus, the level and extent of the leverage each bank can assume should vary as well.
 - Whether they are subject to uniform regulations or left to the discretion of national supervisors, leverage ratios will be compared to one another, so we think it appropriate to disclose the basis for leverage ratio calculations.
 - Components for what is to be included in the calculation, together with the model for the calculation, should be disclosed and subject to monitoring by national supervisors.

5. Constraining procyclicality

■ Overall

- ✧ There are two key points in terms of considering capital buffers from the perspective of constraining procyclicality: (1) the appropriate level of such buffers within the credit cycle, and (2) the appropriate timing for drawing down/rebuilding such buffers.
- ✧ We believe that, if appropriate provisions are made based on the premise of stringent asset assessment, there will be a sufficient level of capital buffers on an accumulated basis, and it will not be necessary to require the establishment of additional capital buffers.
- ✧ It is necessary to establish a mechanism in which the necessary capital buffers are, in a timely manner, drawn down during periods of economic downturn and rebuilt during periods of economic expansion. Consequently, the target level for capital buffers should be variable. Furthermore, so as to avoid a situation in which they, in effect, serve to raise the minimum capital requirement, the operation of the minimum capital requirement and capital buffers should be clarified and capital buffers, like the leverage ratio, should be given a Pillar 2 treatment
- ✧ The Committee states that the four proposals contained in the consultative document are mutually complementary. However, we believe that all four proposals should not be implemented at the outset. In particular, we believe that the proposed regulation concerning capital conservation should not be introduced, as it would limit the right to receive dividends, which is an essential right of shareholders.

■ Paragraph 242 PD estimation to reduce procyclicality

- ✧ The consultative document provides two specific proposals. The first proposal (stress PD) seems to result in excessively conservative PD. As the current PD model already uses a stochastic approach, applying further stress to that model does not seem rational and would result in regulations that include an excessive capital requirement.
- ✧ In the estimation of a stable PD that prevents cyclicity of the minimum capital requirement, a long-term average PD should be used rather than a stress PD. Inclusion of the recent financial crisis period in the observation period should fully resolve the problem of underestimation of the PD.
- ✧ In considering this proposal, thorough research and analysis of discrepancies between actual and estimated PD figures should be conducted on an international basis and each country should decide if data needs to be supplemented by long-term data series. At the same time, care should be taken to avoid excessively conservative PD estimates.

■ Paragraphs 243-246 Relationship between forward-looking provisioning and expected losses

- ✧ With regards to insufficient provisioning against expected losses, the Committee proposes that any shortfall in provisions for expected losses be deducted from common equity, “thus eliminating the capital incentive to under-provision.” If so, then banks should also be allowed to include within the common equity portion any excess provisions over expected losses.
- ✧ We are concerned that the expected loss approach being considered by the IASB will serve to amplify procyclicality during periods of economic downturn, as if a bank’s credit rating was lowered, it would be required to provision for the entire shortfall in reserves at one time. Furthermore, numerous concerns have been expressed over the administrative practicality of the approach, and adopting it would require considerable costs and a considerable preparation period. The Committee and the IASB need to communicate with each other to ensure that the IASB discussion, which has now entered the stage of specific considerations, leads to the establishment of a mechanism that helps to constrain procyclicality.

■ Paragraph 247-259 Building buffers through capital conservation

- ✧ The ICAAP framework, which calls for capital buffers to be managed in a manner that considers risks that cannot be fully captured with the regulatory minimum, should not be dismantled. Here, we think that the issue of capital sufficiency, including capital buffers, should be addressed in the Pillar 2 process, not in Pillar 1. If the minimum requirement is changed within Pillar 1, that could impair the stability of the regulatory framework.
- ✧ In the consultative document, the proposal for restrictions on profit distribution is essentially nothing more than a proposal to raise the minimum capital requirements, despite the Committee’s statement in Paragraph 257 that it does not wish this to be “viewed as establishing a new minimum capital requirement.” Furthermore, there is a danger that this will result in the automatic accumulation of excessive capital buffers that ignore the economic cycle.
- ✧ In company law it is accepted that within the limits of the amount of profits that are distributable, dividends are in principle decided by resolution of a general meeting of shareholders (via a proposal shareholders can take the initiative, for example via a shareholders’ proposal or a shareholder proposed amendment to a resolution of the board of directors). The introduction of regulations that would place broad restrictions on the decision-making mechanism regarding the rights of shareholders to receive dividends (Article 105-2 of the Japanese Companies Act) requires very careful consideration of the legal problems that may arise in relation to shareholders’ rights.
- ✧ This proposal leans toward excess capital sufficiency and, we believe, fails to consider the viewpoint of capital market participants. It would only make the banking sector an unattractive area of investment, one characterized by low ROEs and dividend yields. It could also make it quite

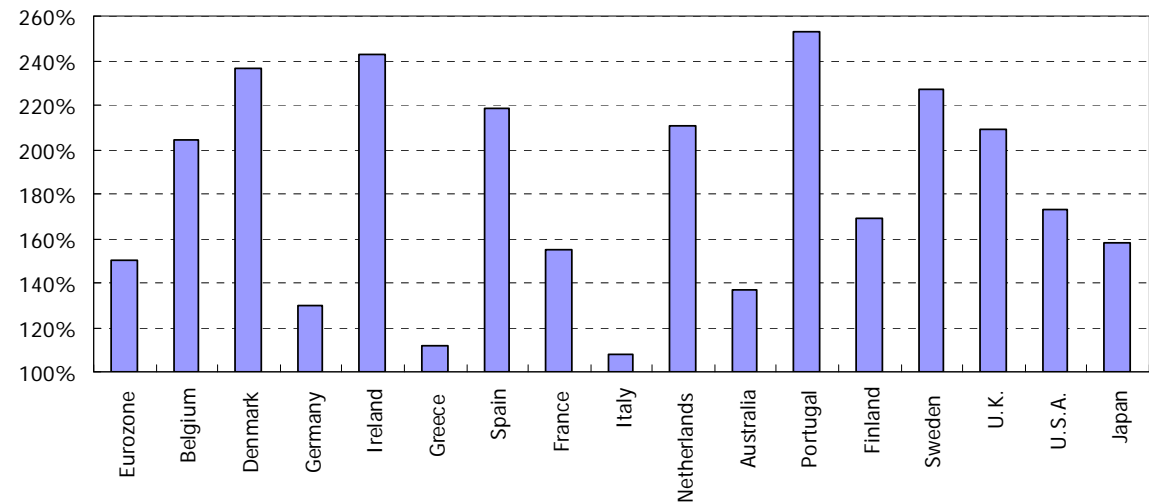
difficult for banks to procure capital, perhaps even leading to a situation in which banks are compelled to constrain their risk assets or, perhaps, become more dependent on their governments. Based on this, we do not believe that these regulations should be introduced.

- ✧ Limitations on discretionary bonus payments should be handled within a separate framework now under discussion. Furthermore, under Japanese company law, directors' bonuses are approved by resolution of a general meeting of shareholders, so there are already some restrictions on excessive bonuses.
- ✧ Among share buybacks conducted in accordance with the exchange of stock, business transfers/mergers and so forth, those that are not intended to reward shareholders or that are not done at the volition of the bank, such as would be the case when honouring repurchase requests from holders of fractional shares or from minority shareholders who are opposed to some reorganizational initiative, should be excluded from this restriction.
- ✧ For both practical and legal reasons, we cannot accommodate a consolidated application. In accordance with company law, dividend-related matters (dividend payment, upper limit on dividend payments, etc.) are, in principle, stipulated on a parent company basis. Also, unless the subsidiary is fully (100%) owned, there is also a need to consider the interests (protection, fair treatment, etc.) of minority shareholders.

■ Paragraphs 260-262 Adjustments to capital buffer range in step with macro-economic conditions

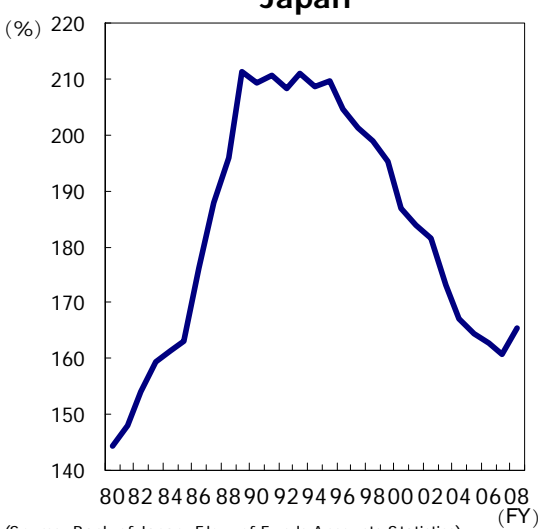
- ✧ Figure 7 shows a comparison of the ratio of corporate plus household debt to GDP for a number of countries. Even though these figures are for the same year, we can see that the level varies considerably between countries. Also the time series data for Japan and the US shows a very large difference in historical movements of this ratio (see Figures 8 and 9).
- ✧ The level and trend of the total credit to GDP ratio in each country must first be considered, and then the level of variable capital buffers should be decided for each country.
- ✧ In deciding upon the level of capital buffers the total credit to GDP indicator could be used as a reference indicator, but consideration should also be given to the effects of credit provision outside the banking sector (direct finance).

Figure 7: Corporate + household debt to GDP CY2008



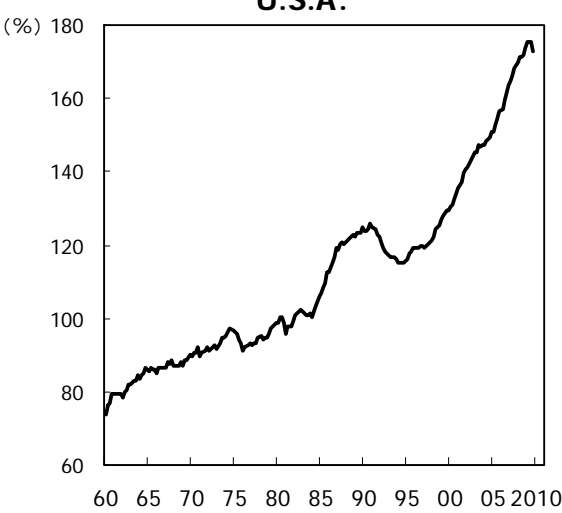
(Source: Data from Eurostat, the Federal Reserve Board and the Bank of Japan)

Figure 8



(Source: Bank of Japan, Flow of Funds Accounts Statistics)

Figure 9



(Source: Federal Reserve Board, Flow of Funds)

International framework for liquidity risk measurement, standards and monitoring

6. Liquidity regulations**■ Overview: general comments on liquidity risk restrictions**

- ✧ The consultative document has been prepared in conjunction with efforts to bolster liquidity risk management in response to the financial crisis that broke out in the summer of 2008. We fully appreciate its importance and necessity, and agree with its underlying philosophy and stance. Furthermore, it reveals an intent to promote the monitoring and control of internationally active financial institutions, together with the financial system in which they operate, based on a shared perspective among the national supervisors of each country, and we think that this direction should be welcomed. We strongly hope that the liquidity metrics that are decided will serve as a benchmark for global liquidity risk management and the Committee will lead a rearrangement of liquidity standards, which vary substantially by country.
- ✧ Liquidity risk profiles can vary greatly depending on, each country's business environment and legal system, together with the particular characteristics of financial markets and banks. Therefore, in essence, globally uniform numerical regulations are not appropriate for liquidity risk management. We consider this liquidity regulatory document is not intended to establish a framework to ensure the prevention of a future liquidity-induced crisis simply by introducing a set of metrics. Rather, we would like to stress that through introducing liquidity metrics to banking regulations, a shared, globally based philosophy (set of fundamental principles) will be created that would facilitate lateral comparisons across countries and financial institutions and enhance communication with national supervisors.
- ✧ First of all, the establishment of a set of globally uniform metrics to ensure that a liquidity-triggered crisis never happen again is, in itself, unrealistic, considering that profiles vary greatly across countries, financial markets and specific banks. Forced attempts to control global liquidity risk by unified metrics, we believe, run the risk of producing extreme inefficiencies. That is, by imposing worst-case assumption factors across the range of regulatory adjustments, the proposals would induce many banks to hold considerably more liquid assets than they truly need, which, from the perspective of the financial system as a whole, would make it very costly to hold liquid assets. Furthermore, the adoption of such control metrics would, we believe, compel banks to shift their asset base from loan assets to liquid assets, thereby impairing the credit creation function that the banking sector is normally expected to fulfil and, by extension, negatively impacting the real economy.
- ✧ On the other hand, for lateral comparisons across countries and financial institutions through establishing a set of metrics, we believe it would be better to make the classification of the asset and liability portions and the various associated conversion factor tables as simple and minimal as

possible, and set the level required by regulation as a minimum, while complementing this by communication between the national supervisor and each bank, based on its own specific liquidity risk profile.

- ✧ Regrettably, in our view, many of the liquidity factors proposed in the consultative document are excessively conservative and far from “minimum standards” in relation to both the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) (for details, please refer to our specific arguments below). Furthermore, because the items are subdivided far more than necessary, and because a number of qualitative items are included as well, the end result is exceedingly complex and hard to understand.
- ✧ In Japan, when we experienced a financial crisis in the second half of the 1990s, each bank improved its liquidity risk management through communication with the financial authorities rather than by strengthening control metrics. The ability of Japanese banks to cope with the recent global liquidity crisis, we believe, attests to the effectiveness of this approach of enhancing liquidity management. Also, there is one factor behind the manner in which Japanese banks were able to maintain their liquidity advantage during this crisis, which is that their previous experience of “Japan premiums” encouraged them to reduce their dependence on funding from the inter-bank market and return to their core business of commercial banking by building on their ample deposit bases. The proposed control metrics reveal that one of their objectives is to rein in businesses that excessively leverage their balance sheet, and we agree with this approach. As explained above, however, we believe that the imposition of globally uniform regulation based on a set of indicators would have a negative impact on the real economy. We thus suggest that the Committee adopts an approach that emphasizes communication with national supervisors, like the approach that proved effective in Japan.

■ Paragraphs 20-70 Liquidity Coverage Ratio (LCR)

Deposit run-off

- ✧ In Japan, deposits are “sticky” (retention rates are high). Looking over past market phases characterized by mounting credit-related concerns, deposit run-off has been significantly less than what is presented as a minimum standard within the consultative document. Using publicly available data to analyse deposit run-off at large banks that eventually failed or were compelled to accept injections of public funds, we find, even on a three-month basis, a maximum run-off about 10%. This was back in the 1990s, when Japanese banks were facing a mounting “Japan premium.” Into this century, the maximum run-off on a three-month basis has been limited to only about 5%. Indeed, the recent financial crisis has had very little impact on deposit balances at Japanese banks. With safety nets now in place, we believe that an assumption of a 5% one-month run-off is sufficiently conservative with regards to the overall deposit balances. In other words, we think that the run-off factors presented in the consultative document are too high and we infer that

the minimum standards do not accord with the actual situations in many other countries and regions as well, not only Japan. We hope that any minimum global standards will be substantially lowered, with detailed settings left to national (or regional) supervisors.

- ✧ Furthermore, the consultative document states that, in order to calculate the amount of cash outflow in 30 days, estimated run-off factors are to be applied, with said factors determined by (1) whether a deposit covered by an insurance scheme, (2) deposit type, (3) depositor attributes and (4) whether there is an established relationship with the depositor. We believe that the definitions are somewhat vague and complex, leading to a result that is difficult to interpret. Especially with regards to whether or not a relationship is established, we believe that there is a strong qualitative element that, while not denying its importance, nonetheless does not lend itself as a base for quantitative standards.

- ✧ Based on this argument, we propose the following deposit categorizations.

With deposit insurance: Uniform rate irrespective of depositor attributes or product characteristics

Without deposit insurance:

Retail, liquid deposits (without maturity)

Retail, term deposits (with maturity)

Wholesale, liquid deposits

Wholesale, term deposits

Financial institutions/public entities, liquid deposits

Financial institutions /public entities, term deposits

- ✧ Similarly, the drawdown assumptions for committed credit and liquidity facilities also seem high in light of the experience of Japanese banks. Even during the recent financial crisis, the maximum monthly rate of increase in draw-downs of the commitment lines of Japanese banks has been limited to less than 3%, which suggests that the assumption of a 10% draw-down within a 30-day period as proposed within the document is too severe. Furthermore, we have to say that a standard that seeks to impose the same conversion factor on overdraft credit lines, which are often used for technical reasons, and guarantees by commercial banks, which are extremely diversified, would be both excessively conservative and unrealistic.
- ✧ We would also like to point out that the proposal is inconsistent with regards to commitment lines involving financial institutions. On the one hand, it is assumed that there will be a 100% outflow when the financial institution is extending the credit, whereas on the other hand, it is assumed that there will be no inflow at all when the financial institution is receiving the credit. When developing their business outside of their home countries, many banks establish commitment lines with local financial institutions for, primarily, local currencies, with said lines serving as an important backup method of fund procurement. If adopted as is, the proposal, we fear, would be highly disruptive for international financial activities.
- ✧ With regards to commitment lines provided by government financial institutions such as the U.S.

Federal Home Loan Bank, we believe that financial institutions should be permitted to include the entire amounts as inflows, as they are government programs.

Liquid assets, cash inflows

- ✧ There are very strict conditions on the inclusion of corporate bonds within liquid assets. For instance, not only are such bonds to receive a substantial haircut and not comprise more than a certain percentage of total liquid assets, they are also to be subject to a verification of market-related characteristics, such as an upper limit on bid-ask yield spreads and price declines over the last 10 years, information that could be very hard to gather. The ultimate effect, we think, would be to make it practically impossible to include corporate bonds within liquid assets, thereby excessively constricting the scope of liquid assets.
- ✧ Furthermore, many assets, even assets not designated as highly liquid, should be able to be monetized to a degree over a month or so even within a stress situation. We think that assets that could be expected to generate cash inflows to some extent (e.g. securities and so forth listed on major markets, bonds falling outside of the high liquidity designation, etc) should also be included as cash inflows after the application of an adjustment factor.

Early termination of term deposits

- ✧ Those term or time deposits of retail clients that “have a withdrawal penalty not materially greater than the loss of interest” should “be treated no differently from other types of deposits and be subject to the same run-off factor as other deposits in the same bucket” regardless of maturity, whereas those that “have a withdrawal penalty that is materially greater than the loss of interest” would not be subject to a run-off factor if beyond a 30-day horizon. In short, withdrawal fees are expected to restrain early terminations during a liquidity crisis. We find this hard to envision. Charging high withdrawal fees that would be disadvantageous to customers would be advantageous for banks in that they would be able include such deposits in the non run-off category. In other words, we fear that this proposed new regulation would, in effect, encourage banks to provide worse customer service.
- ✧ We expect that holders of term deposits view those deposits not as liquid, but rather as something to hold to maturity, so we do not think that there is a link between the size of early withdrawal fees and early terminations themselves. This also leads us to think that all term deposits beyond the 30-day horizon, regardless of whether they have early withdrawal fees not materially greater than the loss of interest, should not be assigned a run-off factor.

■ Paragraphs 78-91 Net Stable Funding Ratio (NSFR)

Positioning of NSFR

- ✧ The introduction of an NSFR is based on the idea that assets with low liquidity should be covered

by stable funding and to an extent we can agree with this. However, we cannot avoid pointing out that we do see a large number of problems in the proposed NSFR framework. Among these we believe that the following two points in particular should be improved.

- ✧ In the calculation of the NSFR, assuming similar stress conditions as for the LCR while also using similar stress factors would, we believe, diminish the significance of the NSFR standard as a complement to the LCR standard. That is, calculating the NSFR under the same set of assumptions as the LCR, despite the fact that the LCR standard pertains to the ability of a bank to cope with a stress situation while the NSFR standard pertains to the stability of the bank's assets and funding during normal times, would seem to run counter to the underlying purpose of the NSFR standard. Standards with differing purposes should take approaches based on differing assumptions. This will, in turn, give meaning to using two different standards.
- ✧ Furthermore, because the retention rate ("stickiness") of deposits is neglected, the larger a bank's deposit base the worse will be the NSFR assessment. This would be extremely severe on traditional commercial banks, which showed relatively high resilience during the recent financial crisis. The NSFR standard requires that banks retain a far larger size of long-term funding compared with that of long-term assets to survive conditions of extended stress over a one-year time horizon. This view, we believe, impairs the ability of banks to supply funds (liquidity) to a broad range of industries and sectors and therefore runs counter to the societal role of banks and their core business model. If the standard were to be imposed in its current form, we believe that it would lead to a restriction of lending and the impact on the overall economy would be strongly negative.
- ✧ We also consider that the financial crisis reaffirmed the importance of deposits to banks. From the viewpoint of encouraging the formation of a stable funding structure, the use of a simpler metrics such as the core funding ratio should also be considered.
- ✧ Above all, in regard to liquidity risk management, the highest priority should be placed on maintaining the required funds in times of crisis, and as noted in the consultative paper it is appropriate that the degree of stability of the funding structure should be positioned as 'supplementary'. The Committee should consider covering the NSFR standard in Pillar 2.

Required Stable Funding

- ✧ During a period of one year it can be expected that a bank could realize funds representing a fairly large portion of its assets through the liquidation of assets, use of collateral, or sale. Ignoring such likely beneficial actions and setting too high a multiple across all assets is not appropriate. There is normally a high degree of diversification in the borrowers from commercial banks and due to this structure a concentrated outflow of funds, such as the situation that occurred at investment banks during the financial crisis, is unlikely to occur. In addition, considering the dangers of negative effects on the real economy, the RSF multiple required in respect of lending and commitment lines to companies should be lowered significantly.

- ✧ As for required stable funding (RSF) factors, it is unclear what is to be included within the “all other assets” category, to which an RSF factor of 100% is to be applied. Depending on definition, the result could be quite unrealistic. We think it would be appropriate to exclude the following items.
 - (1) Customers' liabilities for acceptances (guarantees)
 - (2) Deferred tax assets
- ✧ With regards to foreign exchange transactions carried net on the balance sheet, we believe that the RSF regulatory adjustment should also be on a net basis and only applied in the case of an excess of assets over liabilities.
- ✧ We think that an RSF factor of 85% is too high for loans to retail clients having a residual maturity of less than one year. We do not think that the rollover rate for retail clients is particularly high compared to that for corporate clients. Therefore, we think the factor should be about the same for both.
- ✧ Many loan products, such as residential mortgages, have a high prepayment rate. We think that such prepayments should be reflected within the RSF adjustment.
- ✧ In Japan, many privately placed corporate bonds come with acceptances and guarantees. If the acceptances and guarantees portion of the portfolio is included, the RSF would be double counted. It is thus necessary to exclude that portion.
- ✧ The RSF factor is set extremely high for loans relative to that for marketable securities. If long-term (having a horizon of one year), even a loan asset could conceivably be monetized by, for example, selling it or depositing it as collateral at the central bank, thereby allowing a bank to cover a liquidity shortage. We thus think that the RSF factor for loans should be lowered.

Available amount of stable funding (ASF)

- ✧ Liquid deposits designated as core deposits should be included within the 100% ASF factor category.
- ✧ Various types of provisions on the balance sheet should be either included in the 100% ASF category or excluded from RSF.

■ Paragraph 130-135 Application of indicators for regulations and monitoring tools

Scope of application

- ✧ The consultative document states that “the proposed standards and monitoring tools should be applied to all internationally active banks on a consolidated basis.” We would like to note, however, that a consolidated banking group contains subsidiaries that are active in a variety of business have a variety of balance sheet structures. We believe that the scope of application should be decided in accordance with importance in terms of liquidity risk management and that regulations should have flexibility in the regard.

Frequency of calculation and reporting

- ✧ The document states that the time lag in reporting ideally should not surpass two weeks. We would like to note, however, that because the breakdown of items contained within the proposed metrics is exceedingly detailed, the burden entailed by their calculation is substantial. We think that banks should be granted approximately the same length of time as that permitted for capital adequacy calculations.

Transition period

- ✧ The control metrics proposed by the Committee contain many classifications not included within the traditional framework for the management of liquidity risk. If such finely subdivided control metrics are introduced as is, substantial additions to systems infrastructure would be required for their calculation. We thus ask that you provide a sufficiently long transition period for the introduction of these regulations.

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