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Basel Committee on Banking Supervision

Bank for International Settlements

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baselcommittee@bis.org.

28th June, 2013

**Re: "Supervisory framework for measuring and controlling large exposures
"(BCBS 246)**

Dear Sirs and Madams,

Nomura Holdings, Inc. is pleased to have an opportunity to respond to the Basel Committee on Banking Supervision's consultative document, "Supervisory framework for measuring and controlling large exposures".

Firstly, we would like to express our sincere appreciation for all the efforts the Basel Committee has made to achieve a more appropriate and robust regulatory framework. We fully agree that a large exposures framework should complement the Committee's risk-based capital standard because the latter is not designed specifically to protect banks from large losses resulting from the sudden default of a single counterparty. We also recognize that the minimum capital requirements (Pillar 1) of the Basel capital

framework implicitly assume that a bank holds infinitely granular portfolios, i.e. no form of concentration risk is considered in calculating capital requirements for credit risk assets.

However, we would like to emphasize that for trading book assets, there is no such assumption of infinitely granular portfolios and concentration risk has been properly captured by the introduction of the “incremental risk capital charge” framework. We fully understand the purpose of a consistent backstop regulation encompassing banking book and trading book to prevent banks’ failure in the event of the sudden default of a single counterparty. In this respect, we, at the same time, expect regulatory impact on market-making activities and the wider financial markets is properly addressed.

Therefore, in this comment letter, we would like to focus on how this proposal may affect functionality of financial markets. This includes looking at the provision of investment and fund raising as well as market liquidity carried out through an appropriate pricing mechanism and risk-hedge tools.

In respect of collateral treatment, banks are to add exposures to an issuer of collateral posted to them through reverse repo or security borrowing transaction (hereinafter referred to as “reverse repo, etc.”) on top of the original exposure to the counterparty. However, such aggregation is based on the assumption of almost simultaneous defaults of both counterparty and issuer of collateral shall happen in reverse repo etc. and does not take into account the risk mitigation arrangement of daily margining.

Therefore, we are concerned if the proposed rule may have a material adverse effect even though it is designed for the “worst case scenario”.

In this respect we would point to one of the key concepts of the framework that requires banks to calculate “jump to default loss” with respect to option transactions, while also demanding them to capture “potential” future exposures for a counterparty transaction. As a result, it is anticipated that certain degrees of discrepancy may be caused between a well-accepted way of risk management for trading business and the regulatory large exposure limit management. We are concerned that such discrepancies may hinder the proper functioning of financial markets and could constrain investors and issuers of securities from playing their crucial role in financial markets.

In order to ensure consistency with Basel 3 and other international regulations, “exposures resulting from underwriting” and “exposures to CCP” should receive special consideration. When looking at the treatment of collective investment undertakings, securitization and other vehicles, it is important to recognize the important role they play in the proper functioning of markets and make sure that the relevant regulations are appropriately designed for their use.

We understand the purpose of the proposed regulation is designed as a backstop for risk-based capital rules. The unintended consequence, however, is that a stringent regulation not necessarily complement with best practices in risk management may hinder the proper functioning of financial markets, and, therefore, we have to be careful for the outcome of the regulation being introduced. It is important to consider

the influence on financial markets before finalizing any rules as well as keeping in mind the primary goal that risk-based capital rules should be properly “complemented” by backstop regulation.

We would ask that the Basel Committee consider the balance among other regulations such as Basel 2.5 or Basel 3 where sudden default risk of counterparties is already addressed.

1. Recognition of exposure to issuer of collateral with respect to reverse repo etc.

It can be assumed that if banks enter into reverse repo etc. that there is a chance the creditworthiness of issuers of posted collateral deteriorates and in extremis leads to default. However, in such transactions, banks are margining daily with counterparties as the value of collateral fluctuates. According to the rate of deterioration of credit worthiness of a collateral issuer banks require counterparties to post additional collateral based on margin agreements (until additional collateral is posted, exposure to counterparties may increase).

Under such circumstances, the situation where default of collateral issuer leads to significant impact to banks’ capital base is limited to the case of double default, that is to say almost simultaneous default of collateral issuer and counterparty, and the likelihood of such double default incident can be reasonably recognized when there exists the so-called the specific wrong way risk (“SWWR”). If banks are required to recognize exposure to collateral issuers in addition to a counterparty, in spite of the

fact that there is no SWWR, in reality such regulation may run the risk of impairing the key economic function that reverse repo etc. is supposed to fulfil.

In this situation, where SWWR exists, posted collateral will not be effective as a credit risk mitigation tool, in accordance with the principal objective of capital requirement standard. In addition the exposure to a counterparty will be regarded as “uncollateralized” in the regulatory capital calculation. Therefore, in such case, banks need not recognize exposure to collateral issuer.

In the Basel 3 regulation banks are required to establish sufficient framework to manage SWWR and collateral concentration risk so that reverse repo etc. cannot trigger banks’ failure. Therefore, it can be said that a proper risk management framework has already been implemented in trading business. If uniform standard of large exposure regulation is introduced to cover concentration risk of banking book and trading book, it will constrain the market activities including certain legitimate transactions.

Reverse repo etc., which goes hand in hand with repo transactions and securities lending transactions, are supposed to provide investors with a short-term and high credit quality investment opportunity and enable investors to raise funds without selling the securities they invest in when funding is needed. In some cases investors can enhance their yield by lending the securities to banks. As a result, the securities which can be traded in active repo and lending market are preferred by investors and the market functions well.

If such requirement is imposed on banks intermediating repo or security lending transactions, it may, not by a small degree, shrink the market size and, as a result, investors and issuers of securities may not enjoy benefits.

2. Offsetting of long and short position.

In the proposed large exposure regulation, offsetting of long and short positions with the same issuer is permitted to some extent. For example, when banks hold cash securities long and hedge with a short position through derivative transactions such as a total return swap or credit protection without short-selling, the long and short positions can be offset. However, when banks make a short position by short-selling of cash securities, the position has to be covered by reverse repo etc. to deliver the cash securities to buyers. Then if the borrowed securities have to be recognized as exposure to the issuer of security, aggregated exposure will be the same as non-hedged long position, namely it means that offsetting of a long position and a short position made by cash short-selling is not permitted in the proposed exposure calculation.

In the proposed large exposure regulations, banks are required to apply the substitution approach to trading book position as well as banking book position. However, there is an imbalance in the fact that in the banking book the hedged exposure is simply substituted by the protection provider's exposure and that banks also have to recognize credit derivative counterparty's exposure on top of the hedged exposure of a protection provider in the trading book.

Furthermore, on occasion banks buy protection in the trading book from investors who want to enhance their investment yield by receiving a premium. In this case banks will only recognize a credit derivative counterparty's exposure for the investors.

On the other hand, banks may buy the referenced bond for the purpose of hedging, since such position can be regarded as "credit neutral" and credit spread of the referenced bond can compensate for the premium paid to the investors.

This credit neutral position obliges banks to recognize the hedged exposure of a protection provider in addition to the "naked credit short position". This seems to place banks in an awkward situation that rational behaviour from a risk management point of view leads to an unintended increase of large exposure.

Considering the fact that position management in the trading book is very different from that in the banking book, so it would not be optimal to apply the substitution approach to both trading book and banking book. The differing approach to the same hedged position in risk-based standard rules for the banking book and trading book should be carefully looked at.

3. Recognition of exposure assuming jump to default risk with respect to option transaction.

In the consultative document, it is proposed that exposure to option transactions should be dealt with assuming the extremis position of default. For example, in the case of short of put option, exposure will be “strike price minus market value of put option”.

However, in a trading business, when banks sell a put option to respond to investors’ needs to hedge their investment, transactions to neutralize delta or sensitivity resulting from the put option will be sought for, since this is a primary consideration from the viewpoint of market risk management.¹

For example, in the case of a short at-the-money (ATM) put, delta will be strike price, which equals market price², multiplied by 0.5. So short selling half of the notional amount makes it delta neutral.

On the other hand, the exposure to the underlying security will be as follows. In accordance with the proposed large exposure regulation banks are forced to recognize more exposure in spite of the fact that the position is risk neutral from the viewpoint of market risk management.

Put option : market value of notional amount minus option value

Underlying security : market value of notional amount multiplied by
0.5 negative

¹ Though Delta management is the first principle of market risk management of option transactions, other Greeks like Gamma or Vega management are also needed.

² Since the put is ATM.

Furthermore, when banks make the short position by short-selling of cash securities, the position will be covered by reverse repo etc. then the aggregated exposure will be “market value of notional amount minus option value”³. It means that the large exposure rule will not differentiate the so-called delta-neutral position from “naked”, namely un-hedged, short of a put option, and there will be significant discrepancy between market risk neutral position and large exposure neutral position.

Thus, the proposed framework may differ from well accepted risk management practices in the market. As a result, even if delta neutral position is realized from a risk management point of view, there still remains a considerable amount of exposure. To reduce such exposure, banks may have to have a delta-short position to keep large exposure limit, but, at the same time, those banks will be forced to be exposed against unnecessary market risk due to their compliance with large exposure limit.

The discrepancy between risk-based regulation and large exposure regulation may drive banks into such an awkward situation and complicate their risk management. It may also destabilise the market and increase systemic risks in the worst case scenario.

4. Recognition of exposure brought about by underwriting.

In order to maintain sound functionality of primary securities markets, we would like to ask the Basel Committee to clarify whether positions resulting from underwriting held for five working days or less can be exempt from large exposure regulation. Such

³ Strictly speaking, in reverse repo etc, exposure to collateral issuer is limited to the amount to which credit risk mitigation is applied, however, in this paragraph, the discussion is simplified.

an exemption is consistent with Basel 3 regulation of reciprocal cross holdings in the capital of banking, financial and insurance entities.

5. Exposure to CCP

Considering the regulatory objective that encourages banks to centrally clear all standardised derivative transactions, it would be appropriate to exclude exposure to a CCP from proposed large exposure regulation. This will particularly be the case if a large exposure limit is imposed on derivative transactions settled with a CCP by law, such transaction may be significantly constrained and market participant may be deprived of legitimate risk hedge tools.

6. Exposure to funds, securitization structures and collective investment undertakings (CIU etc.).

The purpose of CIU etc. is to mitigate large exposure risk, and under such a scheme, proper risk diversification and appropriate risk management are essential factors.

There are situations where CIU etc. would be abused to circumvent the large exposure regulation, but, in order to discourage such activity, CIU etc. must be proportionate and appropriate for use as a risk diversification tool. If the rules are too burdensome, it creates a disincentive for institutions to reduce concentration risk by the requirements to look through underlying assets of CIU etc. and monitor aggregated exposure daily.

Though 1% threshold is proposed as a countermeasure, it is anticipated that loopholes will allow circumvention of large exposure limit rules however small the threshold may be. This look through approach requirement may result in an undue burden on proper and legitimate investments.

If a threshold is deemed necessary, the level should be raised so that most of CIU etc. structured in the market can be exempt from the look through requirement therefore reducing regulatory burden. On top of this, supervision should focus on eliminating any loopholes and highlighting industry best practice. We are concerned if the proposed rules may, by not a small degree, impose regulatory burden on legitimate risk diversification tools without appropriately taking into account recent regulatory initiatives that address the abuses of the past. In addition the proposals are contrary to the very aim of a large exposure regulation.

7. Fundamental issues of the proposed framework.

a. Recognition of exposure assuming jump to default risk.

We understand that one of the fundamental aims of the proposed large exposure regulation is the recognition of exposure assuming jump to default as a worst case scenario. However, if the basic assumption is jump to default, it is a consistent approach to recognize only positive mark to market value. This should be $\max(\text{MtM}, 0)$ for counterparty exposures, such as derivatives or security financing transactions.

As proposed, while potential exposures are considered for counterparty transactions, jump to default risk is taken into account for option transactions. If the regulation

applies jump to default risk to option transactions without due care, it may cause some confusion in the pricing mechanism of put options. This is because the proposed regulation will bring about a huge difference of treatment between put options holding banks and writing banks.

The prices of put options may affect the prices of call options as well, and eventually the prices of all the financial products with optionality elements. Under the situation, we are concerned if investors using financial products with optionality face difficulty in achieving proper hedging strategy or a risk return profile in line with the purpose of relevant investments.

In addition, while applying jump to default risk, we are concerned that any regulatory arbitrage may be sought and the purpose of large exposure regulation is impaired as a result.

For example, under the proposed framework, it seems easy to reduce large exposure in the trading book by purchasing a deep out-of-the-money (OTM) put option.

Assuming that a bank purchases bonds which exceed the large exposure limit in its trading book, it can reduce the exposure very effectively by holding deep OTM put option of which the underlying asset is the shortest maturity bond issued by the relevant issuer. For example, if the bank purchases a put option of a good credit bond maturing within six months of which the strike price is, for example, 80%, the premium to be paid will be very small, while the bank can reduce the exposure by the amount of almost 80% of the notional of put option. Such “almost risk free” premium receipts will certainly be attractive to non-regulated market participants.

Thus the proposed regulation will encourage the accumulation of put option transactions between regulated banks and non-regulated entities. It means that contrary to the aim of the regulation a greater interconnectedness will come into existence that has the potential to undermine the stability of financial system.

We would like to suggest that the treatment of put options should be consistent with risk-based position management, that is to say that delta neutral position should be treated as large exposure neutral as well.

b. Use of regulatory approved internal model to calculate potential exposures

If the above-mentioned suggestion is accepted, we understand that potential exposures to counterparty transactions such as derivatives or security financing transactions should also be dealt with.

In that case, we would like to strongly request that banks should be allowed to use potential exposures calculated by the regulator approved internal model (IMM)

It is understandable that the proposed regulation is based on the principle that “a simple, internationally harmonized backstop is needed to complement risk-based capital requirements”. However, we also believe that it does not necessarily lead to the conclusion that an internal model designed for risk-based capital requirements should not be used for large exposure limit, as long as this model is appropriately developed, governed and periodically reviewed under a robust regulatory framework.

The current risk-based capital requirement framework encourages banks to estimate potential exposures for counterparty transactions in a reasonable and risk-sensitive way by continually refining its internal model. Once the internal model is reviewed by regulators and confirmed that it meets strict regulatory requirement, banks are allowed to use the internal model for regulatory capital calculation.

On the other hand, if the model does not meet such a requirement, a more conservative standardized approach will be applied. Such a framework seems very reasonable and incentivizes banks to establish a more sophisticated risk management framework which leads them to make optimal use of limited risk capital. We believe it will lead to a more effective use of risk capital in financial industry.

If the Basel Committee persists in the idea of a “simple backstop”, we are concerned that it will seriously discourage banks from making efforts to have a more sophisticated risk management framework which requires a huge resource commitment encompassing both cost and time.

If the internal model approach is not permitted under any circumstances, we would like to strongly request that the standardized approach, namely the current exposure method (CEM), should be revised so that the result of any calculation may coincide with those of a reasonable risk-based internal model as closely as possible.

In that case, it seems that the requirement of “simplicity” under the standardized approach will substantially increase the costs on businesses. The “gross add-on” which increases as notional amounts accumulate has to be addressed. It is the main

factor that makes a large difference between CEM results and IMM results with respect to counterparties with Credit Support Annex (CSA).

Thus a successor method of CEM is important for any large exposure regulation in order to get the balance right between a simple backstop and risk-based capital standard. Given the importance of this in financial markets, authorities should work together with industry to ensure workable solutions long before the actual implementation of any large exposure framework.

In derivative transactions, banks actively seek to execute CSA with other big players so that mutual exposures are not excessive. As a result the accumulation of notional amounts does not always lead to the increase of counterparty exposure. Therefore, the more banks that enter into transactions with active counterparties, the bigger difference between CEM exposures and expected positive exposures under IMM is likely to be.

Such a big difference has strongly incentivized banks to execute daily CSA with large exposure counterparties and introduce an expected exposure approach which enables banks to measure and mitigate counterparty credit risk reasonably. These efforts of banks have greatly contributed to the sound development of derivative markets and mitigation of systemic risk, and banks have spent heavily to develop internal models and establish robust model governance framework.

If a large exposure regulation which nullifies the significant contribution to financial market achieved by banks' efforts in this area is implemented, it may discourage

banks that are under pressure to reduce costs from negotiating a CSA with counterparties. This will make risk management less sophisticated, and as a result, it may have the consequence of increasing systemic risk.

8. Conclusion : Striking a Balance

Financial market participants, including investors, issuers of securities and intermediating banks, are continuously adapting to ensure the pertinent use and correct risk management of financial products, and believe that that such endeavours will lead to the sound development of financial products and markets. In order to achieve this goal, it is necessary to take into account their influence on risk management practices to prevent dysfunctions within financial markets.

We fully agree with the idea that a simple backstop regulation should complement risk-based capital standard, because the latter was demonstrated not to be sufficient during the financial crisis. However, since the crisis, risk-based capital regulation and banks' risk measurement practice have made significant improvement. Such achievements should be taken into account when considering how the progressed risk-based regulation should be properly adapted.

Even if a risk-based approach did not necessarily work well in the past, it does not mean that "complementary backstop regulation must not be risk-sensitive", or "conservativeness has always to be prioritized to logical consistency". If such

formalism is over emphasized in designing any large exposure regulation, it may cause the potential for circumvention of regulation and increase systemic risk.

We would like to advocate a well-balanced regulatory framework that strikes a balance between risk-based standard and simple backstop, the very aim of a large exposure regulation.

We welcome the Basel Committee's considerations on the large exposure supervisory framework and all the work they are doing to address risk and enhance the global regulatory landscape.

We hope you find our comments useful and, of course, would be delighted to discuss our views in more detail should you find it useful.

Yours sincerely,

A handwritten signature in dark ink, reading "Shigesuke Kashiwagi". The signature is written in a cursive, flowing style with a large, stylized 'S' at the beginning.

Shigesuke Kashiwagi

Executive Managing Director

Chief Financial Officer

Nomura Holdings, Inc.