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Comments on the Basel Committee on Banking Supervision's Discussion Paper:

The regulatory framework: balancing risk sensitivity, simplicity and comparability

Japanese Bankers Association

We, the Japanese Bankers Association, would like to express our gratitude for this opportunity to comment on the discussion paper: *The regulatory framework: balancing risk sensitivity, simplicity and comparability,* released on July 9, 2013 by the Basel Committee on Banking Supervision.

We hope that our comments below will be of assistance and offer an additional point of reference as you work towards finalizing the framework.

General comments

○ Risk sensitivity

Risk sensitivity is the most important measure in the regulatory framework and enhancing it will incentivise financial institutions to improve their risk management framework. Given that the Basel III capital requirements are already being implemented, the next phase involves a thorough assessment of their benefits and impact. This process is considered to be also important from the perspective of ensuring continuity and stability of regulation and supervision.

○ Simplicity

We support the BCBS's idea of pursuing simplicity of the regulatory framework. In some areas, however, issues were discussed at a detailed level and incorporated into regulations without harmonising such discussions across issues. As a result, the level of complexity has increased in such areas as regulation, reporting and disclosure, giving rise to a significant burden for financial institutions. To address this, it is necessary to develop a mechanism where standard-setting bodies holistically review the regulatory framework to make adjustments to or oversee the framework. The priority, however, should not be placed on the simplicity of models.

○ Comparability

Comparability between banks or over time has significance only when such a comparison is made based on risk-sensitive measures that factor in business models or regional characteristics. If it is difficult to make a direct comparison between outcomes, it can be supplemented by performing a benchmark analysis to identify the causes of differences (e.g. differences in parameters used), with financial institutions being accountable for such differences. Consequently, the existence of differences should not necessarily be denied. For example, the difference in skill/know-how of asset management and disposal may constitute a reasonable difference in the estimation of banks' parameters (e.g. LGD).

Additionally, differences in models that are subject to supervisory approval can be controlled by national authorities in each jurisdiction. On the other hand, comparability associated with cross-border differences can be supplemented by establishing a framework that enables supervisory information sharing and mutual recognition between national authorities.

○ Balance

The current capital framework has succeeded in supporting a level playing field and creating incentives for the enhancement of risk management. Performing a gap analysis using benchmarks for the purpose of improving comparability, and holding financial institutions accountable for the outcome should ensure an appropriate balance between simplicity, comparability and risk sensitivity. However, the discussion on achieving the appropriate balance should seek to strike an optimal balance between the operational burden on banks in addition to simplicity, comparability and risk sensitivity.

Further, it is necessary to carefully address, in particular, the buffer structure and calibration of the leverage ratio. If the minimum leverage ratio is raised, this minimum ratio may become the de facto minimum capital requirement even though it should serve as a supplementary measure to the risk-based capital adequacy ratios. For example, where the minimum Tier 1 capital ratio is 8.5% and the average risk weight is 45%, and if the required minimum leverage ratio is 3.8% or more, this could become the de facto minimum capital adequacy ratio. Such cases may result in unintended incentives for banks to reduce low-risk assets and hold high-risk assets. It may also significantly compromise the importance of risk sensitivity although the BCBS recognises this as a central element of regulatory framework.

Specific comments

○ **Q1.**

It is considered that the current framework with its reliance on the risk-based capital at its core appropriately balances the objectives set out in paragraph 29.

Objectives	Comments
Applicability to smaller institutions	The Basel III capital framework requires internationally active banks, regardless of their size, to appropriately capture their risk exposures or risk profiles and sets a minimum level of capital. Moreover, there is a mechanism in place to require appropriate capital add-ons in proportion to the degree of impact on systemic risk. In this regard, a framework applicable to internationally active banks of all sizes is considered to have been established.
Comparability across banks	As various risk factors have been reflected, comparability has improved.
A reasonable level playing field	Under the current framework, each bank can appropriately capture its risk exposures or risk profiles and a minimum level of capital is set. Given this, a reasonable level playing field is ensured.
Effects of capital requirements on banks' risk-taking incentives	The current framework provides appropriate risk-taking incentives by identifying risks properly, avoiding excessive leverage (supplementary measure) and securing prudential liquidity positions.
Enhancement of risk measurement and management	Since the implementation of Basel II, the enhancement of risk sensitivity has been appropriately addressed. Nevertheless, it is considered useful to allow simplified approaches, taking into account materiality and giving due regard to the regulatory burden imposed on banks.

○ **Q2.**

In addition to simplicity, comparability and risk sensitivity, operational burden on banks should also be taken into account in the discussion of how to strike the optimal balance. The introduction of materiality thresholds is considered an effective measure to address this. Additionally, the quality of supervision is also an important factor in assessing the adequate level of simplicity and risk sensitivity. In considering comparability between banks, a framework which also reflects the difference in risk profiles between financial institutions should be pursued.

○ **Q3.**

We recognise that the current capital framework appropriately balances simplicity, comparability and risk sensitivity. Risk sensitivity, in particular, should be viewed as the most important element also from the perspective of promoting banks to enhance their risk management and should not be sacrificed. At the same time, any undue operational burden on banks should be avoided, which can be achieved by allowing certain simplified approaches depending on the materiality of risks.

On the other hand, in some areas, issues were discussed at a detailed level and incorporated into regulations, without harmonising such discussions across issues. This has had the effect of imposing undue operational burden on banks in terms of regulation, reporting and disclosure. To prevent such burden from being imposed on banks, the standard-setting bodies such as the Financial Stability Board and BCBS should make efforts to harmonise similar and/or overlapping areas across their respective regulatory/reporting/disclosure requirements to achieve optimisation of the entire regulatory regime. Further, in order to strike the right balance between the above-mentioned elements, there should be a mechanism whereby standard-setting bodies holistically review the regulatory framework on a regular basis and make any necessary adjustments.

○ **Q4.**

Policy options	Our view and rationale
Introduction of indicators for the assessment of simplicity, comparability and risk sensitivity	[Agree with conditions] We agree with this idea if its intent is to simplify the regulatory framework. Existing regulations should be assessed, through backtesting, to identify which measures succeeded in capturing deterioration of the soundness of financial institutions in times of previous crises. The result of this assessment should be taken into account in simplifying the regulatory framework. At the same time, the BCBS should give due regard to the stability and continuity of the regulatory environment as a frequent review of regulatory frameworks may undermine the stability of the financial system.
Enhancing disclosure	[Further improvement requested] Enhancing disclosure is considered as a reasonable method to improve simplicity, comparability and risk sensitivity. However, it should be noted that, similar to recent developments in strengthening regulations, detailed requirements have been incorporated into the existing requirements, and as a result, such individual disclosure/reporting requirements (e.g. the capital requirements, G-SIFIs disclosure, data gaps, leverage and liquidity requirements) have significantly increased since the implementation of Basel II, which may have been imposing an undue burden on banks. These requirements should therefore be reviewed for duplication and inconsistency, and any similar/overlapping areas, and those identified in disclosures required by respective standard-setting bodies (e.g. the Financial Stability Board and the BCBS) should be hamornised to achieve total optmisation. Further, the type and format of disclosures required by investors may vary, and hence the disclosure regulation should only set out minimum necessary requirements and any issues which are not covered by such requirements should be improved or addressed as necessary through communication between individual financial institutions and related parties.
Using additional metrics	[Disagree] We disagree with the use of additional metrics as it will further complicate the regulatory framework. In particular, equity market values fluctuate in response not only to factors specific to financial institutions but also to various other factors including supply and demand in the markets and speculation among market participants. Moreover, historical equity volatility fails to reflect improvements in

	asset positions after the financial crisis, and not all banks are listed on the stock exchanges. Additionally, the marginal utility of regulation decreases with incremental tightening. Given this, the best option is to pursue an appropriate balance between regulation and supervision.
Ensuring the effectiveness of the leverage ratio	[Disagree] It is necessary to carefully address, in particular, the buffer structure and calibration of the leverage ratio. If the minimum leverage ratio is raised, this minimum ratio will become the de facto minimum capital requirement even though it should serve as a supplementary measure to the risk-based capital adequacy ratios. Such a case may create unintended incentives for banks to reduce low-risk assets and hold high-risk assets. It may also significantly compromise the importance of risk sensitivity which the BCBS recognises as a central element of regulatory framework.
Added floors to internal model approaches (IRB/AMA)	[Floor – Disagree] Adding floors has a negative impact on all aspects of simplicity, comparability and risk sensitivity. First of all, it increases the complexity of the regulatory framework. Secondly, if a floor is breached, a bank's risk exposures may not be presented appropriately, which would undermine comparability between banks. Moreover, the same level of capital charges may be applied to both high-risk and low-risk assets, prompting banks to hold assets with a higher risk relative to profitability. Further, it may disincentivise financial institutions to improve their risk management framework. [Benchmark – Partially agree] A risk weight comparison based on the analysis of factors and backgrounds is considered to be effective. Nevertheless, the existence of differences should not necessarily be denied. For example, the difference in skill/know-how of asset management and disposal may constitute a reasonable difference in the estimation of banks' parameters (LGD). Financial institutions should be held accountable for such differences to markets, investors, and other interested parties.
Use test of internal risk management models	[Partially agree] Assessing the linkage is desirable in that risks can be double-checked and banks can understand the characteristics of both models. However, we disagree with excessively strengthening the linkage because it may act as a disincentive to enhance risk

	management.
Limiting national discretion and improving supervisory consistency	[Agree with conditions or Disagree] It should be noted that regulating and supervising consistently across all banks with different business models or risk profiles will give rise to a situation where some areas are overly regulated while other areas are less regulated. This may increase incentives for arbitrage: specifically, restricting necessary business activities in those areas that are over-regulated, whilst promoting higher-risk investments in the under-regulated areas. The quality of supervision and regulation is enhanced through the ability to monitor based on the knowledge of business practices, risk appetite, business strategies and other aspects specific to each financial institution. Accordingly, national discretion is necessary to a certain extent in terms of supervisory/regulatory approaches.
Improving the accessibility of Basel Committee documents	[Agree] We agree because it will improve convenience.
Addressing factors driving complexity	[Partially agree] We agree with the BCBS's intention to place the highest priority on the timely and consistent implementation of Basel III.
Tangible leverage	[Disagree] The first step to take is to apply the currently-proposed leverage ratio and assess its effectiveness.
Non-use of the internal models approach	[Disagree] This may disincentivise financial institutions to enhance their risk management.
Income volatility	[Disagree] This is not an appropriate metric to measure the soundness of financial institutions. Moreover, adding this metric would further complicate the regulatory regime.
Supervisory controls on financial instruments development	[Partially agree] We agree with this insofar as a means to enhance communication with supervisors, however disagree with using regulation to control financial instrument innovation.
Restriction of activities that are not designed to	[Agree with conditions] Determining whether a business is a traditional customer-oriented banking business requires careful judgment. Therefore, this restriction should not be implemented by a

promote traditional banking business	one-size-fits-all regulation but through supervision.
Improvement of bank resolvability and reduction of global and domestic interconnectedness	[Disagree] The interconnectedness between financial institutions stems from role sharing within the industry and the pursuit of specialty and efficiency founded on the market principles. Reducing this interconnectedness through regulation undermines the sound implementation of market principles.
Elimination of ineffective calculation approaches	[Agree] This contributes to simplifying the regulatory framework.
Improvement of consistency across accounting standards	[Agree] Inconsistency across accounting standards is still one of the impediments to comparability.

○ **Q5.**

We propose to consider allowing the application of more simplified measurement methods (e.g. to apply a fixed risk weight to immaterial exposures) to transactions that are assessed to be immaterial and are not deemed as regulatory arbitrage/circumvent. Further, it is necessary to review the concept of the level playing field. To address this, the regulatory framework should not merely focus on a simple comparison between banks but should adequately reflect financial institutions' business models and risk profiles.