Comments on the Basel Committee on Banking Supervision's "Revisions to the Standardised Approach for Credit Risk" Consultative Document

The National Association of Shinkin Banks
March 27. 2015

The National Association of Shinkin Banks appreciates having been afforded this opportunity to comment on the Basel Committee on Banking Supervision's "Revisions to the Standardised Approach for Credit Risk" consultative document.

Japan's shinkin banks are special-category financial institutions established under Japanese legislation as cooperative structures to serve primarily small and medium enterprises (SMEs) and individuals within clearly delineated geographical regions. The system in its present form goes back over 60 years, and there are currently 267 shinkin banks nationwide plus one Shinkin Central Bank.

We hope the BCBS will take our comments into consideration as it reviews and revises the standardised approach to credit risk.

Overview

The BCBS consultative document proposes reviewing risk weights and possibly making other changes in an effort to devise standards that more reasonably reflect exposure risk and enhance comparability across financial institutions. While we understand the direction and thrust of this review, revising risk weights across the board may sharply reduce capital adequacy ratios for many of the financial institutions that adopt this standardised approach.

As a consequence, financial institutions will be forced to curtail their financing to corporations and the like in order to maintain capital adequacy ratios, which decline in risk capital availability could in turn prove an impediment to their smooth functioning as financial intermediaries, which is their primary purpose, and could have a major impact on industry and even national economies. While we fully understand the importance of ensuring financial institution soundness, we also note the importance of devising rules that do not obstruct these financial institutions as they strive to fulfill their primary mission.

Accordingly, we hope the review of risk weights will be grounded in, for example, the results of the national quantitative impact studies (QIS) and will take full account of the implications and impact not only on the financial institutions themselves but also on the broader national economies.

At the same time, recognizing that most countries have not experienced widespread bank failures and in keeping with the premise that the revisions are not intended to increase the burden on financial institutions, we very much hope the review will focus on realistic risk weight levels that do not impose additional burden on financial institutions.

In reviewing risk weights and other issues, we ask that sufficient preparatory time and transitional measures be allowed in consideration of the administrative burden on small and medium financial institutions.

Specifics

1. Exposures to Banks

It is our understanding that the consultative document is proposing these revisions in light of the bank failures and near-failures sparked by Lehman Brothers' collapse in 2008. Yet we also understand that national authorities have already instituted more rigorous safety nets in the wake of the Lehman crisis precisely to protect against such bank failures. In addition, we note that Japan has not experienced a single bank failure imperiling the financial system since 2004, well before the Lehman crisis. Given this history, we see no need for revisions such as would raise the current risk weights.

The Basel III capital framework[1], for example, allows discretion to take the specific constitutions and legal structures of non joint stock companies such as cooperatives into account.

As cooperative financial institutions, Japan's shinkin banks are complemented by an umbrella Shinkin Central Bank established under the provisions of the Shinkin Bank Act and capitalized by all of the shinkin banks. The Shinkin Central Bank's primary purpose is to manage its member shinkin banks' funds and to handle exchange transactions, with the management of shinkin banks funds entrusted to the Shinkin Central Bank by its member shinkin banks because such cooperative management is seen to be the most rational mode.

Accordingly, it is hoped any review and revision of the standardised approach to credit risk will take the cooperative financial institutions' special characteristics into full account and will admit of arrangements that accommodate these special characteristics, including treating the funds that the shinkin banks place with the Shinkin Central Bank appropriately and not assigning these funds the same risk weight as that assigned funds entrusted across ordinary financial institutions.

We are also concerned that applying the consultative document's risk drivers would worsen the indices for large numbers of financial institutions during an economic downturn and thus work to further exacerbate procyclicality.

2. Exposures to Corporates

---

[1] *Basel III: A global regulatory framework for more resilient banks and banking systems* : Criteria for classification as common shares for regulatory capital purposes "The criteria also apply to non joint stock companies, such as mutuals, cooperatives or savings institutions, taking into account their specific constitution and legal structure."

The consultative document proposes that risk weights for senior corporate debt exposure be determined using the two risk drivers of revenue and leverage. Yet revenue and leverage are but two among the many reference points shinkin banks employ in deciding upon financing to corporates, and far more weight is given to the corporate's financial standing, including cash flow and other factors, and the relationship of trust established with the corporate leadership. The two simple risk drivers suggested in the consultative document are thus at a considerable remove from the reality of shinkin bank exposure to corporates and this revision would be inappropriate in the shinkin bank's case.

Given that the purpose of the revision is to reasonably reflect exposure risk and set appropriate risk weights, rating the applicant based upon a thorough and multifaceted evaluation of the full array of detailed information requested of and provided by the applicant is a far more reliable way to ascertain creditworthiness than is relying upon the two simple risk drivers of revenue and leverage. Likewise, if the corporate receives the same rating from multiple rating agencies, it may be assumed that this outcome is the result of independent actors analyzing the data from different perspectives and the sum may be thought to be a multifaceted assessment.

As such, it is not so much that the simple risk drivers proposed in the consultative document do not adequately represent real risk but is more that they are just two among the many factors needing to be utilized appropriately in external ratings. In this, the cliff effects that can be a problem when using external ratings can be dealt with by further segmenting the risk categories.

Given that a small-to-medium financial institution might find it difficult to adequately manage the wide diversity of highly segmented risk drivers that some shinkin bank corporate clients carry, it is imperative all due heed be paid to crafting relatively simple arrangements including, for example, allowing uniform risk weights to be applied to corporates using rules that the largest possible number of financial institutions can employ to enhance comparability across financial institutions.

Financial institutions deal with a variety of corporates, including non joint stock corporations, and it is also necessary to consider risk drivers for such corporates.

If risk weights for equity and the like are to be revised, that revision should understand the risk weight for the full exposure to the total corporation with the standardised approach and internal based approach rating following a QIS as part of the review, and such understanding should inform the discussion as to the appropriate levels.

As now stands, the risk weight for equity exposures and the like derived using the internal rating based approach is higher than that derived using the standardised approach. Yet the risk weight for corporate, sovereign, bank, and retail exposure can easily come out lower than that using the standardised approach. In fact, the results of QIS5 as released by the BCBS in June 2006 showed the change in minimum required capital for banks in G10 countries to range from –1.3 to +1.7 under the standardised approach and from –26.7 to –1.3 under the advanced internal ratings based approach.

In understanding the total credit risk involved in exposure to corporates, reconciling the risk weight for equity exposures using the standardised approach with that derived using internal rating based approach could well lead to imposing an additional capital burden only on those financial institutions that use the standardised approach, which would be inappropriate from the perspective of calculating the required capital amount. The discussion should thus seek to understand the risk weight for the total exposure to corporates and to hold the capital burden at current levels.

On the issue of reviewing risk weights for specialized lending exposures, revising risk weight for exposures to land acquisition, development, and construction finance as proposed in the consultative document could very possibly make such financing more difficult in regions where there are limited numbers of financial institutions and could very possibly lead to further deterioration in the regional economy. Given this situation, risk weights for specialized lending exposures should be set at levels that will at least maintain current levels.

Because corporate indices tend to deteriorate in times of economic downturn, it is feared that applying all of the risk weights proposed in this consultative document could well exacerbate procyclicality.

3. Real-estate secured exposures (exposures secured by residential real estate)

While in agreement that the risk drivers proposed in this consultative document are appropriate reference points for making an assessment as regards real estate lending, we note that Japan has a relatively low real estate default rate and believe the risk weight has been set so high as to not match Japanese market realities.

Likewise, with regard to debt-service coverage (DSC), which the consultative document suggests as one risk driver, this DSC is at variance with shinkin bank lending practices in Japan, where it is standard practice to look at the person's previous-year earnings before taxes. It is imperative this be given the most careful deliberation in consideration of how it will impact all financial institutions in light of each country's practices as regards lending for residential real estate.

We thus request that QIS be conducted with the broadest possible scope and assuming medium- to long-term periods and that risk weights for exposure to real estate-secured lending be carefully determined in line with the results of these national studies.

Thank you again for the opportunity to comment, which comments we hope are useful to the Committee's deliberations.