

Comments on the Basel Committee on Banking Supervision second consultative document “Revisions to the Standardised Approach for Credit Risk”

The National Association of Shinkin Banks
March 11, 2016

We appreciate the Committee’s affording us this opportunity to comment on its consultative document “Revisions to the Standardised Approach for Credit Risk.”

Japan’s shinkin banks are established and operate under Japanese law as cooperative financial institutions in specifically defined geographical regions, their clientele restricted in principle to small and medium enterprises (SMEs) and individuals. With a history going back over 70 years, the National Association of Shinkin Banks is the umbrella organization for the 265 shinkin banks nationwide as well as the Shinkin Central Bank.

We hope the Committee finds our comments helpful to its review of the standardized approach.

Overview

We appreciate that this second consultative document is the result of careful study building upon the comments received in response to the first consultative document and that it seeks to enhance risk sensitivity and build in greater simplicity.

Yet given the shinkin banks’ portfolios, the proposed risk weighting would actually mean higher-than-present risk weights in almost all categories.

Adopting and applying the proposed risk weightings would thus result in raising the shinkin banks’ capital requirements.

Financial institutions adopting this standardized approach would consequently have to scale back their lending and other capital provision to corporations in order to maintain their capital adequacy ratios, which lessened supply of risk capital could then well have a deleterious effect on industry and the economies of the nations concerned and obstruct the

financial institutions in the performance of their proper role as financial market intermediaries. While well aware of the need to ensure financial institution soundness, we also consider it important the regulations not impede financial institutions' proper functioning.

In addition, we hope that any review of risk weights and the like will take full account of the de facto increase in the administrative burden imposed upon small and medium financial institutions and will allow adequate time for preparation and transition.

Specific Issues

1. Exposures to banks

We appreciate that this second consultative document proposes determining risk weightings not with the first consultative document's risk drivers but with reference to external ratings.

That said, there are a few points to be noted.

While the consultative document proposes exercising due diligence on exposure to banks, the amount of information that can reasonably be obtained on a bank's financial situation, for example, is limited to that in securities filings and other public-record documents. At least in Japan, it is difficult to get information that goes beyond the securities filing when there is no pre-existing lending relationship, and it is unrealistic to expect due diligence premised upon financial information obtained by independent means when the relationship is simply one of an account held.

Similarly, when individual financial institutions conduct their own due diligence, the risk weights derived will vary widely depending upon the amount of information they have access to, their assessment criteria, and other factors, which will lead to an erosion of comparability among financial institutions.

Given this, we hope the standardized approach will not require due diligence for all exposure to all banks. Should such due diligence be required, we further hope the requirement will be structured to accommodate small and medium financial institutions such as might find it difficult to access financial and other information.

The credit risk weight grading as currently proposed entails a major cliff effect. While a one-notch downgrade within the same risk grade does not trigger an increase in risk weighted assets, that same one-notch downgrade triggers an up-to-2.5-fold increase in risk weighted assets if it moves the exposure to a different grade. We do not believe this correctly reflects risk. While we understand that there should be a cliff effect between investment grade and not investment grade, we suggest the table be structured to have less of a cliff effect among investment-grade exposures.

In addition, while it is proposed that the determination of risk weight use ratings not assuming government support, there are very few rating organizations that provide ratings not assuming government support. If the use of external ratings is allowed, we hope this will be interpreted as allowing the use of ratings that assume government support, as most do, so that open data from a broad range of rating agencies can be employed.

There is a very real possibility that the revised standards could trigger an artificial and arbitrary movement of capital as institutions having exposure to banks with lower ratings shift capital at term end to financial institutions that carry higher ratings and hence less risk weight. The implication here is that the lower-rated financial institution would suffer a temporary capital outflow, would find its liquidity sharply depressed, and more; which could very possibly exacerbate instability in financial markets.

The Basel III capital framework¹ states that the application of capital adequacy criteria to cooperative-structured non-stock financial institutions can take their specific constitution and legal structure as non joint stock companies into account.

The shinkin banks are such cooperative-structured financial institutions and have the Shinkin Central Bank as their central institution founded to manage their surplus capital and handle their foreign-exchange dealings, and working through the Shinkin Central Bank is seen as the most efficient way for the shinkin banks to manage their surplus capital. Accordingly, it is hoped the standardized approach will be structured in acknowledgment of the shinkin banks' cooperative structure and that capital placed with the Shinkin Central Bank will be assigned a different risk weight from that placed with an ordinary financial institution.

2. Exposures to Corporates

We appreciate that the risk weights for unrated SMEs needing growth capital have been set lower than those for other corporations.

There are, however, a number of other points to be made in connection with exposure to ordinary corporations.

The legal restrictions on shinkin bank lending prevent them from lending to major corporations. As a result, the bulk of their exposure to corporations takes the form of corporate bonds and the like, and the amount of information that they can access about these corporations is limited largely to their securities filings and other public-record data. It is very difficult for financial institutions to access information and perform due diligence on

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."

corporations that they do not have a lending relationship with, and this in turn erodes comparability among financial institutions.

Should full due diligence be required, the result could well be that financial institutions finding it difficult to conduct such due diligence also find it difficult to invest in corporate bonds and the like while those that can do the due diligence find the cost of conducting the due diligence makes the investment less attractive, the end result in either case being that the corporate bond market shrinks, uncertainty increases, and events unfold to negatively impact the real economy.

Given this, we do not think due diligence should be required on all corporate exposure, and if it is required, we hope the system will be structured so as to take due consideration of the plight of those financial institutions that find it difficult to access the necessary data, e.g., because they do not have loans outstanding.

On investment funds, the principle is to calculate the risk asset using a look-through approach, yet the administrative cost of doing due diligence on each target individually at the same level as if the bank itself owned the instrument is such as to render this unrealistic.

The credit risk categories as currently proposed embody a very sharp cliff effect. While it is unavoidable that there should be some cliff effect between investment grade and non-investment grade, just as there is for exposure to banks, we suggest a table be structured taking quantitative impact studies (QIS) results into consideration and lessening the cliff effect among investment-grade securities.

3. Subordinated debt, equity and other capital instruments

We appreciate that the risk weightings this consultative document proposes for subordinated debt, equity and the like are lower than those proposed in the first consultative document.

That said, they still represent a considerable increase over the risk weightings in current practice. In reviewing the risk weightings, it is hoped more reasonable criteria can be arrived at by, for example, taking QIS results into account and comparing the impacts of the standardized approach and the internal rating based approach.

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. Because the Shinkin Central Bank provides a safety net for the shinkin bank industry and otherwise plays a crucial role for the stability of Japan's financial system, the funds that the shinkin banks provide for its stable operation are not viewed as investment funds. We thus hope the risk weighting structure can be configured to set their risk weights different from those for ordinary equity and capitalization in light of the shinkin banks' special characteristics as cooperative financial institutions.

4. Real estate exposures

We appreciate that this consultative document represents a rethinking from the first consultative document's stipulation on DSC ratio referencing that was divorced from the Japanese reality.

That said, it should be recognized that Japan's default ratio on residential real estate is a very low. In particular, the consultative document's proposed risk weighting for real estate when repayment depends upon the cash flow generated by the property is excessive and at variance with the Japanese reality.

We thus ask that, in setting the risk weight for general exposure including all of collateralized real estate exposure, the broadest possible leeway be built in, medium- to long-term QIS be conducted, each country's QIS results be taken into account, and the risk weighting be most carefully studied.

5. Off-balance sheet exposures

At least in Japan, almost no unconditionally cancellable commitments are used to their full extent. While we understand risk weighting is intended to anticipate future risk, it seems excessively conservative to apply the risk weighting to the whole of the commitment when it is unknown how much might be drawn down, and we hope the risk weighting can be set in light of, for example, the average utilization balance over the course of the year.