Comments on the Consultative Documents

The Japan Research Institute, Ltd. appreciates the opportunity to comment on the Basel Committee’s consultative document “Strengthening the Resilience of the Banking Sector” issued in December 2009.

Capital adequacy regulations have played a dominant role in enhancing the soundness of financial institutions, and have also functioned as passports for financial institutions in lowering the barriers for doing business abroad by presenting a unified global standard.

In the consultative document, the Basel Committee is considering to strengthen capital adequacy rules to address the lessons of the financial crisis. However, in order to cope with the crisis as well as prevent another crisis from happening, it is necessary to consider comprehensively with other regulations and supervisions. Also, when discussing the strengthening of capital regulations there should be considerations as to whether it is appropriate to uniformly implement, without reservation, regulations worldwide that are of different nature from the existing ones. From such kind of perspective, we would like to make comments based on the following viewpoints.

1. Re-examination of the effects and influences of capital adequacy regulations.
We consider this re-examination necessary as a precondition to discuss raising the quality and level of the capital base.

2. Evaluation of the characteristics of capital adequacy regulations.
This should be a prerequisite in discussing how to cope with procyclicality issues and other negative effects on the actual economy.

3. Re-definition of the role of each of the “three pillars”
This sorting will be necessary when introducing capital buffers and leverage ratios.

4. Consideration of accepting diversity in the financial system
We believe this is a necessary prerequisite in the decision of how to treat intangible assets and deferred tax assets.

In each section, extremely important issues are labeled “Main” and important issues labeled “Sub.” Lastly, we have listed the issues where we would like to have explanations on the background of the proposals.
【Structure of Paper, Summary and Points of Issue】

Section 1: Summary

This section summarizes the Document. Here, discussions are based on presenting existing capital adequacy regulations and arguing the need to strengthening them. We are pointing out that in the first place, a review of the capital regulations framework itself and the role it has been playing is necessary. We also question whether it is appropriate to strengthen the capital base in coping with what had happened in the recent financial crisis, and whether it is better to combine other various regulations instead.

Section 2:

Chapter 1  Raising the quality, consistency and transparency of the capital base

In this chapter, the Committee stresses the importance of reinforcing the capital base of financial institutions as means to prevent the recurrence of financial crises and proposes reforms that would improve the quality, consistency and transparency of the regulatory capital base. To this, we ask why is it necessary to single out common shares and retained earnings and distinguish them as the predominant components of Tier 1 capital, while at the same time assert the need to treat intangible assets and deferred tax assets in a manner that is in line with the specific situation of each country.

Chapter 2  Risk coverage

In this Chapter, the Committee proposes to strengthen the capital requirements of counterparty credit risk exposures arising from derivatives and to address the excessive reliance on external credit ratings. To this, we will offer comments on the issues of understanding the risks of securitization products using external credit ratings, the treatment of securitization and re-securitization products as eligible collateral, and the scenarios for stress testing.

Chapter 3  Leverage ratio

In this Chapter, the Committee introduces a leverage ratio and proposes to not only put emphasis on the assets side but, taking into account the contraction of high-risk liquid assets, to also consider the liabilities side. Our Comment assumes that excessive leverage was a key element in the current crisis, but also warns against reinforcement of “the risk-based requirements, with simple non-risk-based ‘backstop’ measures based on gross exposure.” The key elements to the definition of capital in the design of the leverage ratio are listed, and among them is the treatment of off-balance sheet netting. To this, we ask whether we should also be emphasizing the quality of the liabilities side.
Chapter 4  Procyclicality

This Chapter contains proposals for containing procyclicality and defining the capital buffer range. Our Comment calls attention to the limits to controlling the fluctuations in the minimum capital requirements using the internal rating-based approach of Basel II; and the problem with introducing a framework of capital buffers above the regulatory minimum that would in effect severe its links with the economy.
**Section I**

**Comment 1. [Main]**

Before considering any additions to the three pillars of the Basel II Capital Accord, the Committee needs to reexamine the roles of each pillar and to what extent they actually functioned during the financial crisis.

**Reason/Explanation**

Without first examining the effects of the three pillars, discussions on reinforcement of the Basel II Capital Accord would not necessarily contribute to raising the resilience of the banking sector. Such measures may only generate effects that strengthen procyclicality. Instead of merely accepting the reinforcement of the existing framework as a given, we should sufficiently examine which elements were effective and which were not under the existing framework; and only then discuss measures to improve and add on to the framework.

**Comment 2. [Main]**

Paragraph 14 defines Tier 1 capital as capital that absorbs losses on a going-concern basis. An explanation is required as to why common shares and retained earnings are considered to be the predominant forms of Tier 1 capital. Shouldn’t there be other components that should be included as Tier 1 capital? For example, a clear explanation is necessary if there is a major difference between preferred shares and common shares in terms of their capacity to absorb losses.

**Reason/Explanation**

The mechanism for the capital base to absorb losses varies according to whether it is on a going-concern or a gone-concern basis. This is because, in the case of a going-concern, there is the possibility that prior to reducing the capital base, losses will be disposed of through the appropriation of profits. Since dividend payment is not mandatory on common shares at the time losses are incurred, there is no doubt that such shares would be effective in absorbing losses on a going-concern basis, as they may be used to dispose of losses instead of paying out dividends. However, there is insufficient explanation as to why the predominant forms of Tier 1 capital for loss-absorption on a going-concern basis are to be limited to common shares and retained earnings.
Comment 3. [Sub] (Paragraph 25)

The statement, “migrating (the leverage ratio) to Pillar 1 treatment,” should be reconsidered. Shouldn’t it be better to focus on the liability side as to where the problem lies? The adoption of these measures could lead to the inclination of banks toward high-risk assets and the reduction of liquid assets.

(Reason/Explanation)

The Consultative Document states its intention of “migrating (the leverage ratio) to Pillar 1 treatment.” However, if, as a result of this measure, the reduction of total assets becomes binding, it would very likely encourage the inclination toward high-risk assets. Therefore, careful consideration is necessary before implementing uniform restrictions in the form of Pillar 1 treatment that may motivate financial institutions to lean toward high-risk assets.

Comment 4. [Main] (Paragraph 30)

In terms of procyclicality, there is a need to reexamine and resolve the issues posed by the Basel I framework.

(Reason/Explanation)

The Consultative Document focuses on the issues of procyclicality posed by the Basel II framework. However, structural issues relating to procyclicality were also inherent in Basel I, which stems from the fact that the framework imposes minimum capital requirements as a certain proportion of assets. Consequently, shouldn’t we consider the reexamination and resolution of these issues first?

Comment 5. [Sub] (Paragraph 51)

The Committee needs to reconsider whether liquidity risk can be dealt with by regulating individual financial institutions.

(Reason/Explanation)

The recent financial crisis is said to have emerged as a result of the manifestation of liquidity risks and the market dysfunction precipitated by the spread of such risks. The Consultative Document, thus, advocates the adoption for individual financial institutions of a 30-day liquidity coverage ratio and a structural ratio for long-term assets. However, as the current financial crisis has shown, once market functions are down, funding can become extremely difficult. Therefore, it is doubtful whether simply seeking conformity to a single uniform standard would be sufficient.
【Summary of Chapter 1, Section 2】

In this chapter, the Committee stresses the importance of reinforcing the capital base of financial institutions as means to prevent the recurrence of financial crises and proposes reforms that would improve the quality, consistency and transparency of the regulatory capital base. To this, we ask why is it necessary to single out common shares and retained earnings and distinguish them as the predominant components of Tier 1 capital, while at the same time assert the need to treat intangible assets and deferred tax assets in a manner that is in line with the specific situation of each country.

Comment 6. [Main]  
(Paragraphs 66-74)

If Tier 1 capital is defined as capital that absorbs losses in order for the bank to continue as a going-concern, why is it, then, necessary to single out common shares and retained earnings as the predominant components and rigorously distinguish them from other components of Tier 1 capital?

(Reason/Explanation)

Without doubt, common shares and retained earnings are the highest quality components, in terms of absorbing losses (Paragraph 66). However, for other components to be included in Tier 1 capital, they must satisfy the rigorous criterion of being able to absorb losses while the bank remains a going-concern (Paragraph 67). Paragraph 72 states, “The required features for instruments to be included in Tier 1 capital outside of the common equity element will be strengthened.” Consequently, elements included in Tier 1 capital should uniformly be assured of their high quality and thus there seems to be no need for singling out common shares and retained earnings as predominant parts. For the sake of simplifying regulations, we believe that the category of Tier 1 would suffice and the distinction of its predominant parts is unnecessary.

Setting minimum standards on not only Tier 1 capital but also on its main components could also adversely impact the economy. In order to clear these requirements, financial institutions could end up making a succession of massive capital increases, which otherwise would have been used for growth, thereby locking investments in the financial sector and preventing them from reaching the sectors that actually need them the most.

Furthermore, these large-scale capital increases by financial institution could increase the ratio of foreign investors, which, in turn, could lead to changes in corporate governance.
Comment 7. [Sub] (Paragraphs 97-99)

The Committee proposes to deduct goodwill, as well as other intangibles, from the Common Equity component of Tier 1 capital. Shouldn’t there be consideration for the situation of each country? Shouldn’t similar consideration be made, in terms of deferred tax assets?

(Reason/Explanation)

Paragraph 97 states, “Goodwill and other intangibles should be deducted from the Common Equity component of Tier 1.” The deduction of goodwill prevents financial institutions that have enlarged their asset size through repeated mergers from enjoying an edge over financial institutions that have expanded through independent efforts. However, this could also encourage financial institutions, after having acquired another, to promptly dispose of the purchased asset, which, in turn, could have a disincentive effect on long-term corporate management. We request an explanation on the Committee’s stance toward such negative effects.

To begin with, items included in intangibles vary from country to country; and to ignore these differences and uniformly deduct these items altogether is highly problematic.

Similarly, Paragraph 98 states, “Deferred tax assets … should be deducted from the Common Equity component of Tier 1.” We are concerned that deferred tax assets are uniformly being deducted from Tier 1, despite such assets being treated differently according to the tax systems of each country.
【Summary of Chapter 2, Section II】

In this Chapter, the Committee proposes to strengthen the capital requirements of counterparty credit risk exposures arising from derivatives and to address the excessive reliance on external credit ratings. To this, we will offer comments on the issues of understanding the risks of securitization products using external credit ratings, the treatment of securitization and re-securitization products as eligible collateral, and the scenarios for stress testing.

Comment 8. [Main]  (Paragraphs 178-188)

The Committee expressed concerns over the excessive reliance placed by many market participants, including banks, on external ratings. However, isn’t this a natural outcome of the Basel II Capital Accord, which endorsed external ratings for measuring risks? Considering the highly volatile exposures of securitization products (which is also the cause of cliff effects), it certainly seems unreasonable that the current regulatory framework would try to measure risks by using credit ratings, whether they are external or internal, as they only represent expected losses.

(Reason/Explanation)

Ratings only represent EL and PD and not UL or volatility. Thus we need to go back and reexamine the validity of using such ratings to measure risks of securitization products that are highly volatile.

Comment 9. [Sub]  (Paragraphs 146 and 162)

Recognizing securitization products as eligible collateral while not recognizing re-securitization products, which are comprised of securitization products, may pose problems concerning the consistency and integrity of the regulatory system. Shouldn’t there be a clear explanation on the differences in risk profiles between the two?

(Reason/Explanation)

The Committee needs to explain the reasoning behind categorization of re-securitization products separately from securitization products from the perspective of their risk profiles. We believe that the disparity in the treatment of the two products, despite being both highly volatile and equally ill equipped as collateral, is counterintuitive to the principle of risk-sensitivity of the Basel II Capital Accord.
Comment 10. [Sub] (Paragraph 173)

In terms of stress testing, we believe that, in addition to the programs listed in this Paragraph, it is essential to set up scenarios that include systemic risks. No matter how rigid the requirements are made for stress testing, if the requirements do not include scenarios for systemic risk, the stress testing would hardly produce effects that are commensurate with the huge injection of management resources. If it is difficult for individual financial institutions to assume scenarios involving systemic risks, the stress testing should be implemented based on scenarios indicated by (or with) the regulatory authorities.

(Reason/Explanation)

Counterparty risk results from a correlation of providing and obtaining credit among financial institutions, and this interconnection of risk often results in systemic risk. So even if rigorous requirements were set up for the stress testing of individual financial institutions, unless the assumed scenarios included systemic risk, which became manifest in the current financial crisis, it would not sufficiently provide the means to withstand financial crises and would only entail exorbitant costs. If it is difficult for individual financial institutions to assume scenarios for systemic risk, the use of scenarios set up by the regulatory authorities is also a possibility.
【Summary of Chapter 3, Section II】
In this Chapter, the Committee introduces a leverage ratio and proposes to not only put emphasis on the assets side but, taking into account the contraction of high-risk liquid assets, to also consider the liabilities side. Our Comment assumes that excessive leverage was a key element in the current crisis, but also warns against reinforcement of “the risk-based requirements, with simple non-risk-based ‘backstop’ measures based on gross exposure.” The key elements to the definition of capital in the design of the leverage ratio are listed, and among them is the treatment of off-balance sheet netting. To this, we ask whether we should also be emphasizing the quality of the liabilities side.

Comment 11. [Main] (Paragraph 202-206)
Introduction of the leverage ratio may not necessarily be the most effective method of preventing paralysis of market functions due to deleveraging. Shouldn’t it be better to focus on the liability side? The adoption of these measures could lead to the inclination of banks toward high-risk assets and the reduction of liquid assets.

(Reason/Explanation)
During the current financial crisis, financial institutions that had built up excessive leverage were forced to accelerate the process of reducing leverage, which had the effect of expanding losses through the downward pressure on asset prices and further exacerbating the crisis.

However, the introduction of a leverage ratio seems unreasonable. This is because effective measures for preventing deleveraging would be impossible without first focusing on the assets side (quality of liabilities). For example, prior to the crisis, the five major investment banks in the U.S. had leverage ratios of 25 to 30 times, while today, after the Lehman collapse, the leverage ratio is down to approximately 10 times. Despite the rapid fall of the leverage ratio, there is no guarantee that similar deleveraging will not occur in the future. Once credit impairment has taken hold of a financial institution, the deleveraging process is set in motion, even with lower leverage ratios.

As indicated above, the problem lies in the vulnerability of funding on the liabilities side, i.e. the large proportion of funds raised in the short-term market. Therefore, it is not about the leverage ratio that we should be concerned but rather the proportion of funds being raised in the short-term market.

Furthermore, shouldn’t liquidity assets be deducted? For example, in certain countries such as Japan, the volume of deposits exceeds the volume of loans, and certain financial institutions conduct asset management by holding government bonds. Requiring such financial institutions to dispose of their government bonds for the sake of the leverage ratio would seem futile. Instead of focusing merely on the assets side, the treatment of liquidity assets (cash, government bonds and the like)
should be considered, taking into account the results of the impact assessment of liquidity restrictions and its mutual effects.

Comment 12. [Sub]  

(Paragraphs 206 and 210-215)  

In terms of the design of the leverage ratio, the treatment of so-called netting, or the off-setting of receivables against debt, seems to lack consistency.

(Reason/Explanation)  

In this Consultative Document, the Committee has defined the leverage ratio as Capital (Tier 1 or Common equity elements) / Total exposure (Total assets of the balance sheet + Off-balance sheet items). For the sake of clarity and transparency, total assets are to be based on accounting data.

According to Paragraph 212, netting through collateral is not allowed, while Paragraphs 214 and 215 also broadly disallow netting. This, however, seems to be contradictory to the treatment of investment in subsidiaries proposed by the Committee, which is to be based on a risk-based approach. In a risk-based approach, measurement is made after consolidation, whereas if we were to follow the preferred method mentioned above, measurement should be made for each legal entity prior to consolidation.

Comment 13. [Sub]  

(Paragraphs 229-234)  

The Committee states that it “considers that the advanced approaches of the Basel II framework are not appropriate for a non-risk based measure of leverage.” However, if derivatives are simply to be aggregated for the purpose of measuring leverage, it could create disincentives for risk-hedging transactions and possibly hinder risk-mitigation. Therefore sufficient care needs to be taken in the design of such a system.

(Reason/Explanation)  

Although measuring leverage is considered to be “supplementary,” if the non-risk based treatment of derivatives is to be limited to the simple aggregation of such derivatives, it could not only force banks to correspond to both the non-risk based and the existing risk-based regulations, but also discourage the use of derivatives for their original purpose of risk-hedging.
【Summary of Chapter 4, Section II】

This Chapter contains proposals for containing procyclicality and defining the capital buffer range. Our Comment calls attention to the limits to controlling the fluctuations in the minimum capital requirements using the internal rating-based approach of Basel II; and the problem with introducing a framework of capital buffers above the regulatory minimum that would in effect severe its links with the economy.

Comment 14. [Main]  
(Paragraph 240-246)

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<th>The problem of procyclicality already existed prior to Basel II, at the time of Basel I. The problem was considered to be structural as it stems from the fact that the framework imposes minimum capital requirements as certain proportion of assets. Consequently, there is a need to reexamine and resolve this issue.</th>
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(Reason/Explanation)

In order to ease the vicious cycle (spiral) of amplification of the economic downturn precipitated by the credit crunch, there is a need to put a damper on procyclicality. During recessions, it is difficult for financial institutions to strengthen their capital base, and so they are forced to reduce their risk assets. Even if the banks that have adopted the IRB method of Basel II were to calculate the PD based on long-term data, it would only ease, not contain, procyclicality.

Comment 15. [Main]  
(Paragraphs 256-262)

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<th>The Committee proposes to develop a regime, “which would adjust the capital buffer range, … when there are signs that the credit has grown to excessive levels.” To begin with, the very mechanism of regulatory capital requirements is such that minimum capital requirements will decrease during economic expansion periods when credit is on the increase. Consequently, trying to implement controls by using buffers seems to point to a fundamental glitch in the design. Is there an absolute distinction between minimum capital requirements and buffers, in the first place? Assuming that such a distinction does exist, there is no need to set uniform buffer levels worldwide, as is the case with the minimum capital requirements, rather such matters should be left to the discretion of each country. In this context, there is a need to redesign the Basel II framework itself. Regulatory capital requirements, by nature, determine the upper limits of credit. As stated in Paragraphs 260-262, when it is determined that “credit has grown to excessive levels,” the capital buffer range is adjusted. This indicates that the supervisory authorities will make judgments on the credit environment and determine the total volume of credit, which, in turn, suggests that it is up to</th>
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the supervisory authorities as to what the total volume of credit in the economy will be. Consequently, a thorough reexamination is called for.

(Reason/Explanation)

The increasing awareness of the importance of capital as a buffer to absorb losses on a going-concern basis necessitated the qualitative improvements to the capital base. Meanwhile, establishing the two separate concepts of capital buffers and minimum capital requirements would ensure the sound management of financial institutions but would also likely result in the deterioration of capital efficiency overall. If the Committee is to seek capital buffers in addition to the minimum capital requirements, a reexamination of what distinguishes the two is called for. For example, assuming that a two-tier standard for capital requirements and capital buffers is established, if a financial institution satisfies its capital requirements but is short in capital buffers, it will surely lose its credibility in the market. For this reason, we must question the rationale behind setting up a two-tier system. Even if a two-tier standard were necessary, whether or not there is a need to have international agreement on their levels is still open to dispute. In such cases, individual financial institutions will simply operate under new minimum standards that include the capital buffers, which would, in no way, eliminate the problem of procyclicality.

Furthermore, in order to prevent discretion of supervision authorities in setting capital distribution constraints, a mechanism based on macro-economic variables should be considered.
【Comments common to Section I and II】
The following comments are forwarded for the purpose of requesting detailed explanations on the rationale behind the regulations. We believe that sufficient grounds should be indicated when strengthening existing or introducing new regulations.

Comment 16. (Paragraph 20)
The Committee has requested the strengthening of capital buffers for counterparty credit risks related to derivative transactions; repurchase transactions, and securities financing transactions by banks. Consequently, the grounds for such proposals need to be clarified.

(Reason/Explanation)
Counterparty credit risks had existed in the past, but in the absence of any specific measures, it has come to be recognized as a major risk in the recent financial crisis. However, there has been little discussion on the methods of measuring or controlling such risks. If the Committee insists that capital requirements are to be strengthened in the presence of such risks, the basis for the calculation of such risks should be clarified. If the new capital requirements for counterparty credit risks are to be introduced as an incentive for concentrating transactions at exchanges, which will dissolve counterparty credit risks, such measures are to be comprehensively judged against the loss of efficiency resulting from the strengthening of the capital requirement.

Comment 17. (Paragraph 35)
The Committee states that it is advocating a change in accounting standards concerning provisioning towards an EL approach. Such changes seem to be inconsistent with basic accounting principles, which exclude arbitrariness.

(Reason/Explanation)
The Committee advocates changes to accounting standards in terms of provisioning practices. Under current accounting standards, general provisions are usually posted according to a certain basis, such as the adoption of a provision ratio based on credit losses that have actually been incurred in the past several years. However, the EL approach may allow for a certain amount of discretion to the financial institutions in calculating the amount and may also allow for arbitrary manipulation in accounting. This could lead to a distortion of the fundamental accounting principle, that is, the exclusion of arbitrariness.
Comment 18. (Paragraph 12)

The Committee claims to provide protection against model risk and measurement error. However, the method of calculation is unclear and must be clarified.

(Reason/Explanation)

Some have cited the problems inherent in the risk model itself or the insufficient data measurement period for the model as the causes for the failure of risk management in the recent financial crisis. Even if we are to further reinforce the capital requirements as means to address these issues, it is necessary to clarify the basis for calculating the additional amount of capital required to protect against model risk and measurement error.

Comment 19. (Paragraph 21)

Clarification is necessary on the reason why “Credit valuation adjustment – CVA” with counterparty risk is necessary and also why different treatment from ordinary loans is required.

(Reason/Explanation)

The Consultative Document requires a capital charge for the purpose of providing for mark-to-market losses (credit valuation adjustment - CVA – risk) associated with deterioration in the creditworthiness of a counterparty. However, a similar charge is not required for ordinary loans. The reason why CVA is necessary for derivative transactions, repurchase transactions and securities financing transactions of banks needs to be clarified. The Consultative Document states that mark-to-market losses have been greater than those arising from outright defaults. However, the relationship between the two losses has not been documented.

Comment 20. (Paragraph 21)

The Consultative Document mentions the strong interconnectedness of exposures of financial institutions. However, we believe that this is not necessarily applicable to all financial institutions.

(Reason/Explanation)

Not all financial institutions that conduct derivative transactions are engaged in complicated trades involving multiple parties. It is quite often the case that small and medium financial institutions make one-way use of derivatives for the purpose of hedging for themselves. Consequently, not all financial institutions are strongly interconnected, and there needs to be considerations that more accurately reflect reality. In terms of small and medium financial institutions, should risk exposure
be raised because of strong interconnectedness, it could very well become a barrier for risk hedge transactions.

Comment 21.  

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<th>Paragraph 60</th>
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<td>Although the Committee states that the regulatory capital framework must “capture the key risks to which a bank and the banking sector are exposed,” there is no mention of how it intends to tackle this task in the Consultative Document. An explanation is required.</td>
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<td>Paragraph 60 acknowledges, “It is critical that the regulatory capital framework captures the key risks to which a bank and the banking sector are exposed.” However, the Consultative Document offers no clear explanation on how it intends to realize this task.</td>
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Comment 22.  

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<th>Paragraphs 61 and 67</th>
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<td>The Committee states that the banks’ capital was of insufficient quality. However, it does not state in what way capital was insufficient or what kind of effects such an insufficiency entailed.</td>
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| Paragraph 61 states, “The global banking system entered the crisis with capital that was of insufficient quality.” The fact that many key banks received injections of public funds proved that capital had been insufficient in terms of quantity. However, how did the Committee conclude that the quality of the capital was insufficient? Which capital components were scrutinized in the midst of the crisis in terms of their quality? And what effects were generated through such insufficiency? These are some of the questions that need to be answered.  

Furthermore, Paragraph 67 states, “Certain innovative features that have been introduced over time to Tier 1 to lower its cost, have done so at the expense of its quality.” Questions, such as what exactly is this passage referring to as having sacrificed quality, and why this happened must be answered. |
Comment 23. (Paragraph 84)

The disclosure rules applicable during the grandfathering period must be clarified.

(Reason/Explanation)

Paragraph 84 states, “Given the significant changes proposed to the definition of capital, the Committee recommends that members consider the possibility of allowing the grandfathering of instruments that have already been issued by banks.” However, the disclosure rules during the grandfathering period are not clear. If disclosure were required on the capital components to which grandfathering had been approved, then, in the market, financial institutions would most likely be evaluated on the capital base calculated by the new definition. In such cases, the advantages of grandfathering would diminish and certain financial institutions could effectively be put at a disadvantage. In order to avoid such a situation, we believe it best that disclosure rules during the grandfathering period are left as they are.

Comment 24. (Paragraph 85)

We find it puzzling that the minimum standards of x%, y% and z% of risk-weighted assets must be assigned to common equity, Tier 1 Capital and Total Capital.

(Reason/Explanation)

Paragraph 85 states, “Common Equity, Tier 1 Capital and Total Capital must always exceed explicit minima of x%, y% and z% of risk-weighted assets, respectively,” and imposes three numerical criteria concerning the capital requirements on financial institutions. However, risk-weighted assets, which serve as the common denominators, only represent a portion of the risks facing the financial institutions and do not accurately reflect asset trends during the year as only the year-end balance are used. Consequently, it is questionable whether exhaustive calculations of the three criteria using risk-based assets and rigorously imposing them on financial institution would actually be effective.

Comment 25. (Paragraph 87)

Since banking systems vary by country, is it really effective to set uniform criteria for classification as common shares?

(Reason/Explanation)

Paragraph 87 lists 14 criteria used for “classification as common shares for regulatory capital purposes.” However, taking into account the difference in laws (such as companies acts), legal
systems and business practices of each country, is it reasonable to apply uniform criteria across the board? Even if identical criteria were applied, it is doubtful whether global consistency, in effect, would be ensured.

Comment 26. (Paragraph 89)

Requiring prior supervisory approval for repayment of principal seems to be problematic.

(Reason/Explanation)
Paragraph 89 lists the criteria to be met in order for an instrument to be included in Tier 1 Additional Going-Concern Capital.Criterion No. 6 states, “Any repayment of principal must be with prior supervisory approval.” If this were the case, repayment of principal would be influenced not only by economic rationality but by political and governmental discretion as well. This could dramatically increase its opacity in the eyes of investors. Furthermore, such a move would increase the uncertainty involved in the pricing of the instrument, in cases where the liquidity of the instrument has diminished or when it is a private placement; and could increase the possibility of putting other existing shareholders at a disadvantage. There is a need to clarify the criteria for supervisory approval or the criteria for the repayment of principal.

Comment 27. (Paragraph 101)

The Committee states that if a bank holds common stock in a financial institution that exceeds 10%, then the amount above 10% should be deducted. We would like to know what exactly the basis for this 10% is. We would also like to know whether this 10% rule should also be applied to banks that hold stocks in multiple financial institutions.

(Reason/Explanation)
Paragraph 101 states, in terms of “investments in the capital of certain banking, financial and insurance entities, which are outside the regulatory scope of consolidation,” “if a financial institution has holdings of common stock that exceed 10%, then the amount above 10% is required to be deducted.” However, the grounds for the calculation of “10%” are not made clear. Furthermore, if a financial institution has holdings of common stock in other financial institutions, which in aggregate exceed 10%, then the amount above 10% must also be deducted. Cases where a bank holds a limited number of stocks in multiple financial institutions, however, will not necessarily evoke systemic risks and thus could render this rule unnecessary.
Comment 28.  
(Paragraph 108)  
What is the basis for applying 1250% risk weight to certain assets? 

(Reason/Explanation)  
Paragraph 108 states that regulatory adjustments, which are currently deducted 50% from Tier 1 and 50% from Tier 2, and which are not addressed elsewhere, should receive a 1250% risk weight. This will be applied to certain securitization exposures which are subject to deduction of credit, the EL of certain equity exposures under the PD/LGD approach, non-payment/delivery on non-DvP and non-PvP transactions; and significant investments in commercial entities. The two calculations - first, making deductions from capital, the numerator, and second, applying 1250% to assets, the denominator - yield nearly identical results. However, it should be made clear why a risk weight is being added to the denominator, while deductions are being made from the numerator for all other items. This may be a matter of formality, but it seems to be making the system more complicated than it should be.

Comment 29.  
(Paragraphs 135-139)  
The Committee states that since “financial institutions are more correlated to each other than non-financial institutions, a multiplier of 1.25 will be applied to the asset value correlation (AVCs) of financial firms.” Details of the analysis behind this figure need to be disclosed. Furthermore, applying this multiplier to financial institutions beyond the scope of analysis may be unreasonable.

(Reason/Explanation)  
Since the Consultative Document does not disclose the results of the analysis conducted by the Basel Committee, verification of the correlation between the financial institutions and the levels of AVCs is impossible. The rationale behind the application of this multiplier to financial institutions that were not included in the scope of analysis also needs to be explored.

Comment 30.  
(Paragraphs 135-139)  
Does the fact the Committee has proposed “the application of the multiplier of 1.25 to exposures to regulated financial intermediaries with assets of $25 billion or more and exposures to all non-regulated financial intermediaries” suggest that non-regulated financial intermediaries are prone to greater systemic risks? In such cases, it would seem more appropriate to distinguish between the exposures to regulated financial institutions and the non-regulated financial institutions, and apply different AVC multipliers.
In terms of financial institutions that would be subject to higher AVCs, the Committee has set quantitative criteria for exposures to regulated financial institutions, i.e. financial institutions with total assets of $25 billion or more, while it has not based criteria for exposures to non-regulated financial institutions on asset-size. This suggests that the Committee estimates risks of the latter to be greater. If this risk involves systemic risks, it would seem more appropriate to raise the AVC multiplier to be applied to exposures to non-regulated financial institutions above 1.25 (or instead, to lower the AVC multiplier for exposures to regulated financial institutions to below 1.25).

Comment 31. (Paragraphs 118-122)
In order to address general wrong-way risk, the Committee advocates the metric of Effective EPE, which takes into account data from the stress period. However this would completely compromise the basic principle of the Basel II Capital Accord, namely its risk-sensitivity. Moreover, it would seem to be overly conservative to further reinforce regulations when wrong-way risks are already being calibrated by adding on the multiplier Alpha at the time of Effective EPE measurement. Such requirements could also raise issues of consistency and integrity of the system.

(Reason/Explanation)

The Committee proposes, in order to address general wrong-way risk, “banks must use the maximum of the Effective EPE calculated using (1) data from the three-year period that includes the one-year stressed period that is used for the Stressed VaR calculation in the updated trading book rules for market risk, or (2) current data based on the most recent three-year period.” However, taking the stressed periods into account at all times seems excessively conservative and inconsistent with the principle of Basel II, which is oriented toward risk-sensitivity. Furthermore it is questionable whether it is necessary to impose duplicate requirements when wrong-way risks are already being calibrated by adding on the multiplier Alpha at the time of Effective EPE measurement.

Comment 32. (Paragraph 249)
The Committee states, “these options should be discussed with supervisors as part of the capital planning process.” However, this seems to run counter to the major premise of these regulations, namely that of ex-post supervision under transparent and consistent rules. Although it is said that restrictions on capital in this buffer range would not limit the bank’s operations but would be in the form of capital distribution constraints, it would seem that the new
buffer range would become the new minimum capital requirement and once again encourage procyclicality. An explanation is required on why this requirement may be considered a response to procyclicality.

(Reason/Explanation)

Dividend policies are truly matters of management. Although universal rules are necessary, it is questionable whether prior discussions with the supervisory authorities, which could become discretionary, should be made mandatory.
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