Japan Securities Dealers Association

Tokyo Shoken Bldg.
5-8, Kayabacho 1-chome, Nihonbashi, Chuo-ku
Tokyo 103-0025, Japan
Phone : (813) 3667-8451 Fax : (813) 3666-8009

September 10, 2010

Mr. Nout Wellink
Chairman
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Mr. Wellink,

The Japan Securities Dealers Association (JSDA)[1] is pleased to respond to the consultative proposal on *Countercyclical capital buffer* and appreciate the work done so far in the Basel Committee on Banking Supervision (BCBS). While understanding that this proposal mainly aims at "protecting the banking sector from the credit cycle," the JSDA would like to provide its comments focusing on the bearings of the proposal on the stability of the macro-economy and capital markets. We hope that our input will be of some help to your committee's further deliberations on this issue.

The consultation paper states that the proposed "countercyclical capital buffer" is to be introduced "to ensure that the banking sector in aggregate has the capital on hand to help maintain the flow of credit in the economy without its solvency being questioned, when the broader financial system experiences stress after a period of excess credit growth." We share the view that regulatory capital requirements on banks exacerbate cyclical change of the economy and, in particular, constrain the banking sector's supply of credit during the period following excess aggregate credit growth. Therefore, the counter cyclical capital buffer proposed to mitigate such procyclicality should be given high marks. This said, in order for the proposed framework to achieve the aim without impairing the stability of capital market and, eventually, of the economy, the following points deserve due consideration when putting the framework into actual operation.

1. Calibration and operation of capital buffers

By nature, capital buffer ranges should be determined reflecting the differences in each jurisdiction's financial and economic regimes and situations. Nonetheless, the range of capital conservation buffer is anticipated to be set in a uniform and fixed manner without fine tuning to the reality of each jurisdiction. Therefore, it is highly likely that the capital conservation buffer will be regarded as a part of required minimum capital. Accordingly, there is a concern that the capital conservation buffer may go too far beyond its intended function and have adverse effects on the efficiency of the real economy and capital

[1] Japan Securities Dealers Association (JSDA) is a hybrid association functioning both as a self-regulatory organization (SRO) and as a trade association in the Japanese securities market. Its legal status is that of an organization established under the Financial Instruments and Exchange Act. Under the law, the JSDA has been granted authority by the Prime Minister. The JSDA's more than 500 members consist of securities firms and other financial institutions operating securities businesses in Japan.

markets through excessive restraints on banks' intermediary functions and unduly stimulate new stock issues in capital markets beyond their absorption capacity.

In view of this, it is advisable that the authorities in each jurisdiction be given discretion in determining the range and time to implement the capital conservation buffer. Unlike the capital conservation buffer, it is highly appreciated that the countercyclical capital buffer is defined as a mechanism for which each jurisdiction can variably adjust the range in response to its economic situation and business cycle.

At any rate, the required level of capital buffer differs from jurisdiction to jurisdiction reflecting financial and economic regimes, bank supervision structure including safety-net measures, business models of individual banks, economic situations and business cycles. In light of this, the operation of capital buffer requirement including the nature and method of distribution constraints imposed when the requirement is not met should be left to the discretion of each jurisdiction's authorities.

As one specific instance, it may be a fairer and more efficient option to set the capital buffer as a reserve deducted from not after-tax but before-tax profit and used only for disposal of nonperforming loans. Setting capital aside from before-tax profit will avoid an excessive burden on financial institutions in high tax rate countries and improve efficiency in building the capital buffer (reserve) driven by the tax incentive. If the accumulated capital buffer (reserve) exceeds the required level, the excessive amount of buffer (reserve) can be taxed when the buffer is turned off. Such treatment could avoid problems arising from the use of funds for a purpose other than originally intended.

2. Distinction between capital buffers and minimum capital requirement

Under this proposal, two layers of capital buffer, that is, the capital conservation buffer and the countercyclical capital buffer, are added above the regulatory minimum Tier 1 capital requirement. As referred to in Annex 1, the BCBS recommends that these buffers should be carefully calibrated so that the upper bound of the aggregated buffer range would not be viewed as establishing a new minimum capital requirement.

However, banks will be given a strong incentive to maintain capital levels in excess of the capital conservation buffer because the capital conservation buffer is assumed to be set at a uniform fixed level in each jurisdiction and because constraints on distributions of earnings, which seriously affect stockholders' rights to receive dividends, will be imposed when the capital conservation buffer is not met. Owing to these two reasons, market stakeholders are also likely to judge banks' soundness by viewing the aggregated level of minimum capital requirement plus capital conservation buffer as the actually required minimum capital standard.

The consultation paper proposes to operate the capital conservation buffer using discrete bands by which the degree of distribution constraints imposed on banks are phased according to the size of the bank's capital conservation buffer deficiency. In this regard, the paper describes, "The Basel Committee does not wish to impose constraints for entering the range that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement." Notwithstanding the "discrete bands" approach, individual banks will probably struggle to avoid even the lightest constraints, fearing reputation risks and complaints from stockholders resulting from the distribution constraint penalty imposed by the authorities. Furthermore, the proposal states that the consequences of not meeting the countercyclical buffer will be the same as not meeting the capital conservation buffer, which means further constraints on distribution of earnings.

Seeing through to the essence of the matter, one of the major factors behind viewing capital buffers as a part of the minimum capital requirement is that distribution constraints are imposed when banks fail to meet the buffer requirement. Therefore, in order to clearly distinguish the countercyclical capital buffer from a minimum capital requirement, it might be worth considering not linking the countercyclical capital buffer to the across-the-board constraints but accommodating it through specific measures under Pillar 2.

3. Impact of countercyclical capital buffer on market

In order to avoid the distribution constraints, banks need to meet the counter cyclical buffer requirement through retaining earnings, raising capital or cutting lending growth. In the case that a sizable countercyclical capital buffer is added on, it seems difficult for banks to enhance their capital by way of retaining earnings or raising capital during the 12-month preannouncement period. Banks may consequently have no choice other than the third option, that is, cutting lending growth. While the consultation paper points out a moderating effect on the build-up phase of the credit cycle as a positive side benefit of the proposed buffer, there is a concern that the proposed buffer may not just moderate the credit growth but cause a credit crunch due to simultaneous depression of lending by banks. This may result in a hard landing in the economy.

As device to avoid such consequences, we would recommend considering leaving the length of preannouncement period to the discretion of each jurisdiction's authorities rather that fixing it at 12 months, or, conversely, fixing the preannouncement period but flexibly adjusting the range of the add-on buffer.

4. Implementation of countercyclical capital buffer (Reconsider positioning it as Pillar 2)

The consultation paper clearly states, "The countercyclical capital buffer is not a Pillar 2 approach." At the same time, it mentions, "Its use of jurisdictional judgment also makes it distinct from the current Pillar 1 approach," and "Irrespective of whether it is considered to be a Pillar 1 approach, it is essentially a disclosed requirement that would sit on top of the capital conservation buffer and minimum capital requirement, with a pre-determined set of consequences for banks that do not meet this requirement." Since not only the capital conservation buffer but also the countercyclical capital buffer are to be highly transparent mechanisms that require disclosure of their principles and standards, we infer that the basic thinking of the BCBS is that both buffers may as well be regarded as virtually the same approaches as Pillar 1.

Underpinning this way of thinking seems to be the basic position by the BCBS that, during the authorities' decision-making process for capital buffers, it will be important to focus on communication with stakeholders in order to achieve policy objectives. This being said, if the numerical criteria for the capital conservation buffer and countercyclical capital buffer are disclosed to the public, market participants are likely to view the upper border of these two layers of capital buffers added on the existing minimum capital requirement as the de facto new minimum capital requirement. Particularly, taking into consideration that distribution constraints will be imposed as a penalty when the required buffer ranges are not met, the proposed capital buffers will be inevitably viewed as a new minimum capital requirement.

On the other hand, the announcement by a national authority to turn off, or reduce the level of, the countercyclical capital buffer will serve only to declare that the jurisdiction's financial system is facing widespread stress. It is difficult to judge at the present stage whether market players will feel relieved when made aware of the level of the buffer, or feel uneasy in reaction to the fact that the broader financial system in the jurisdiction is under stress. There is a concern that market players' judgment and following responses could lead to a consequence completely opposite to the policy objectives, that is, further instability in the financial system.

While we would never deny the importance of communication and disclosure in capital markets, the relationship between capital markets and financial systems is not so simple. Careful examination will be needed to discover whether the disclosure and simply increased transparency of decisions regarding capital buffers will really contribute to improving the stability of financial systems. In this regard, we are concerned about the BCBS's position of categorically denying the option of implementing the countercyclical capital buffer through Pillar 2 approaches.

Before closing, we would like again express our appreciation for this consultative process that the BCBS is taking with market stakeholders. In our belief, such a collaborative approach is imperative for the development of efficient and effective global regulatory standards for financial and capital markets. We hope our comments will assist your committee's further deliberations. If you have any queries, please feel free to contact us.

Yours sincerely,

Tetsuo Mae

Tetsuo Mae
Chairman