Japan Securities Dealers Association

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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] welcomes the opportunity to comment on the consultative proposals for *Strengthening the resilience of the banking sector* and *International framework for liquidity risk measurement, standards and monitoring* and appreciates the discussions and deliberations regarding them so far in the Basel Committee on Banking Supervision (BCBS). While most of the proposed measures will mainly affect banks, they also are likely to have a major impact on the financial and capital markets and on the economy overall. From the perspective of the Japanese securities industry, it is very important to get the proposals right and well-calibrated so that the future regulations will contribute to the stability of global capital markets. Therefore, as a major stakeholder in capital markets, the JSDA is pleased to provide its current thinking on these proposals. Because the two consultative documents issued by the BCBS encompass a great many detailed and technical points, our comments below focus on issues to which we attach particular importance. We would greatly appreciate you and the committee members taking our views into full account in your deliberations, moving forward.

We note that the consultative proposals have not yet suggested specific measures to help dampen *Procyclicality* at this stage. Nor are specific measures regarding *Contingent capital* available at this time as their discussions are scheduled for July this year with those addressing the risk of *Systemically important institutions* slotted for October. In addition, the deadline for submitting comments on the current proposals is April 16, a point at which the results of the quantitative impact study (QIS) will not be yet available. Therefore, we would like to suggest that, if necessary, additional comments be accepted after the deadline and additional specific proposals should be brought to public consultation so that the committee will ensure appropriate dialog processes with market stakeholders.

1. Capital Framework

While it is important to ensure a level playing field for internationally active banking institutions, the differences in financial institutions' business attitudes toward risk–taking

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[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.

and governance structures have proved to have large implications for capital adequacy. These differences should be more explicitly noted in the current exercise. This point is evidenced by the fact that Japanese or other financial institutions—which were following risk management strategies different from those of US/European institutions—were relatively less affected by the recent financial crisis. Besides the business attitudes toward risk-taking, differences among jurisdictions also can be found in the depth of short-term money and foreign exchange markets, taxation systems (which significantly affect deferred tax assets), systems and methods of banking supervision (particularly the frequency and depth of on-site inspections), accounting and audit systems, as well as procedures for public fund injection and insolvency regimes in the case of a banking crisis. We are concerned that uniform regulations excessively focused on capital requirements without proper consideration of such differences among jurisdictions may lead to skewed risk-taking incentives and impair the stability of real economies and financial markets and make it difficult to ensure a level playing field among jurisdictions.

As noted in the basic principles of Basel II, Pillar 1 (minimum capital requirements) can function as balanced regulation only when effectively combined with Pillar 2 (supervisory review process) and Pillar 3 (market discipline). In designing the future regulatory framework, therefore, the BCBS will need to attach proportionate weight to Pillar 2, which reflects the diversity among jurisdictions, and Pillar 3, which seeks to enforce market discipline through effective disclosure.

2. Coherent Regulatory Framework without Excessive Regulation

Our most serious concern with respect to the proposed regulation is that excessively tight regulations on market transactions may create a vicious circle whereby a decrease in market liquidity leads to further declines. While market dynamics may amplify overreaction and make it easier for uneven distribution or accumulation of risks to occur, we are worried that certain elements of the BCBS's comprehensive proposals might discourage providers of market liquidity. We believe that an increase in market liquidity without any overconcentration or accumulation of risks should be regarded as an effective step toward achieving the ultimate goal of establishing a more robust financial system. We reiterate that the vast range of risks such as market risk, counterparty risk and liquidity risk can be managed most effectively through greater market liquidity.

At the same time, we believe that any increase in capital surcharge on securitized products must deliberately reflect a fair and appropriate amount of underlying risks in such a manner as not to hamper the sound development of the securitization markets, in particular, for emerging countries that need efficient financial intermediation to fund their future growth via these markets. The merits of securitized products remain firmly valid today for highly developed financial markets as well, particularly in providing vehicles for liquidating illiquid assets such as mortgage loans, allowing banks to offload these assets from their balance sheets and make funds available for lending and investment, as well as in responding to institutional investors' demands for highly liquid products as investment choices. Also, the repo and securities lending operations as well as derivative transactions can contribute to more sophisticated risk management practices of financial institutions in dealing with risks in liquidity and price volatility. In this regard, we urge the BCBS to reconsider some of the proposals—the treatment of netting when calculating leverage ratio for example—in order not to impair the merits of such products and transactions and hamper sound development of financial and capital markets.

Another point supporting our sense of caution is that the proposed revision aims to regulate banks uniformly in emerging countries as well as those in developed countries, paying scanty attention to differences in their phases of financial and capital market development. For example, the corresponding deduction approach for a reciprocal cross holding between banks, if introduced universally, might harm the sound development of capital markets, particularly in emerging economies that implement restrictions on foreign ownership of banks. Furthermore, across-the-board introduction of regulations to address problems in most advanced markets could result in enlarging the chasm in the level of sophistication and development between highly-advanced and other markets.

One more important point to note is the need for a comprehensive approach. If capital requirements are designed only through piecemeal approaches that require the build up of capital buffers against specifically identified risks, the overall capital framework may prove to become incoherent or excessive. Moreover, the leverage ratio is closely related to the liquidity standard, underscoring the need for a comprehensive approach. For example, Japanese banks constantly maintain deposit amounts in excess of lending amounts in reflection of the current economic structure and hold massive amounts of Japanese Government Bonds (JGB). Therefore, a simple comparison of their capital (numerator) and total assets (denominator) on balance sheets would show the leverage ratio of Japanese banks to be relatively low. However, the inherent credit and liquidity risks of JGB holdings are extremely limited. If this reality were to be ignored and JGB holdings included in the denominator of the leverage ratio, Japanese banks' leverage ratio would decrease and their intermediary functions would be seriously diminished.

Such differences in the balance sheets of banking institutions across the different jurisdictions reflect not only the risk preference of depositors and investors but also macroeconomic factors including the savings-investment balance in each jurisdiction. Accordingly, the introduction of an across-the-board leverage ratio ignoring such diversified structures of financial and capital markets—if that in fact occurred—would run the huge risk of bringing about unexpected adverse effects on domestic and global financial flows as well as market interest rates. Therefore, we would suggest that government bonds not be added on to the denominator of the leverage ratio and that leverage ratio rules be enforced in a flexible manner suited to each jurisdiction under the Pillar 2 and Pillar 3 frameworks.

3. Attention to Economic Conditions

The downturn of the real economy after the financial crisis has deteriorated the quality of bank assets and increased credit risk. In countries that had inflated real estate and housing bubbles, the commercial real estate and household sectors may suffer from the bursting of bubble for a longer period of time than normally expected. As the case now stands, losses in the trading portfolios of financial institutions have already been realized but unrealized holding losses in their lending portfolios are likely to remain as risks over a long period of time until economies have attained a full-scale recovery. Since trading activities underpin the functioning of capital markets, excessive regulation imposed on trading as well as lending activities would seriously impede the banking sector's intermediary role in providing the corporate finance essential to the restoration of economic growth. In this regard, we are deeply concerned that BCBS's proposals on risk coverage could have a serious negative impact on the accounts of banks, including the application of a higher multiplier to the asset value correlation of exposures to financial firms. We therefore suggest that the BCBS make sure that the cumulative capital charge to strengthen the risk coverage does not become too punitive.
If enhanced capital requirements were to hamper the economic recovery, they would impair the soundness of bank assets, inviting an unintended vicious circle. Before the introduction of revised standards, therefore, there is a need for careful impact assessment from long-term and macroeconomic perspectives. In order to avoid the new or revised regulations hampering the pickup of business activities, appropriate phase-in measures and grandfathering arrangements should be applied for a sufficiently long period, as indicated in the consultation documents.

We agree that reducing procyclicality and promoting countercyclical buffers are of pivotal importance. The consultative documents have not pinpointed specific measures for this objective. Taking into account the differences in economic climates among jurisdictions, it would be sensible to leave the specific measures to the discretion of the authorities in each jurisdiction in the context of strengthening the Pillar 2 approach.

4. Impact on Market

The set of proposals attaches particular importance to the common equity component within the minimum capital requirement. While sensible, the proposals have already trigged a rush of new stock issues by financial institutions. The ability to absorb common equity is relatively scarce in the overall economy, entailing risks that the cost of equity finance would become generally higher for the economy as a whole when strong recovery is needed. There is a concern that financial institutions may need to boost the common capital component beyond the capacity of capital markets to absorb new stock issues. At the same time, the enhanced leverage and liquidity ratios will generally reduce the capital efficiency of financial institutions. Granted that the common equity component should be the core of capital requirement, the BCBS should carefully calibrate the contents and introduction process of the new capital framework paying adequate attention to the market structures and environment including the absorption capacity in capital markets.

5. Particular Concerns about Specific Measures

Among the proposed measures, we would like to comment on the following points about which we have particular concerns.

1) Corresponding Deduction Approach to Reciprocal Cross Holdings between Banks

In response to the proposals, financial institutions need to strengthen their high quality capital by issuing common stocks. However, as major part of such stocks have to be underwritten by financial institutions regulated by the Basel II framework, it is important to make sure that the proposed rules will not undermine the sound functioning of primary capital markets. For that reason, it is necessary to implement a rule which exempts underwritten positions from capital deduction for a certain period after underwriting, provided that these positions are hedged by measures such as corresponding short positions taken under an appropriate internal risk monitoring system.

The proposed capital charge could also create negative incentives for market making activities, which respond to investors' trading needs and provide liquidity to the markets, adversely affecting the liquidity provision as a result of decrease of market participants. Consequently, careful consideration would be called for in order not to impede banks' capital raising activities.

The most important measure for strengthening resilience in the banking sector, while avoiding capital injections by central governments, is to encourage more private investment in risk capital. Improving the attraction of investments from the investor's perspective is vital to that purpose.

2) Deduction of Deferred Tax Assets from Tier 1 Capital

Despite the existing differences in taxation systems among jurisdictions, the consultative documents contain a proposal to require an across-the-board deduction of deferred tax assets from Tier 1 capital. It would be important to make sure that the proposal not undermine the incentives for banks to build provisions for the future where there is significant divergence in taxation as well as supervisory practices.

3) Treatment of Protection Selling with Respect to Leverage Ratio Regulation

If only short positions of CDS would be included on a notional value basis into a calculation of the leverage ratio as proposed, the denominator of leverage ratio might rise drastically. This would seriously affect supply and demand in the CDS market, possibly creating an adverse impact on market liquidity. We may lose the means for hedging if market liquidity dries up. Therefore, it would be suggested that, giving due consideration to the result of QIS, the proposal should be adjusted or, if necessary, reconsidered so that the CDS can continue to be an effective tool in hedging CVA risk.

4) Treatment of High Rated Bond (single A or above) and Listed Shares with Respect to Liquidity Regulation

We believe that listed equity securities, particularly large cap stocks, as well as corporate bonds with relatively higher credit ratings of single A or higher, have demonstrated that they can maintain sufficiently high market liquidity even during times of stress. We are highly concerned that the unduly high RSF (Required Stable Funding) factor of 50% for these securities proposed for the Net Stable Funding Ratio calculation does not reflect their intrinsic liquidity and believe it is too conservative even for times of stress. The problem is that all these conservative factors are likely to affect the banks' investment decisions during normal times and might materially hurt the market liquidity of these assets. The undesired but likely scenario for this result is that the contraction in proprietary trading activities would lead to wider buy/sell spreads, which will in turn affect investors' demand, and, eventually, could hamper the functioning of the primary market and impede corporate finance activities. We therefore call for deliberate calibration of RSF factors such that the introduction of new liquidity risk measurement will not hamper the proper functioning of markets in normal times.

6. Measures for Systemically Important Financial Institutions

The Financial Stability Board (FSB) is developing strategies to address the risk of systemically important financial institutions (SIFIs). The BCBS's proposals and the FSB's initiatives to this end should be consistent with each other and avoid creating duplicative or excessive regulation. SIFIs should be defined and selected by each country's authorities in an internationally coordinated manner taking into account economic and market conditions. It would be inadvisable to uniformly treat them simply based on their scales or licensed businesses. Measures for the selected SIFIs should be designed considering their costs and benefits as well as each jurisdiction's insolvency proceedings for failed banks. In countries where insolvency proceedings have been well-established, the risk of SIFIs could be addressed by alternative supervisory measures (e.g. more frequent inspections) as substitute for additional capital requirements.

In closing, we appreciate the collaborative and comprehensive consultative approach the BCBS is taking with market stakeholders. We believe such an approach is essential for the development of efficient and effective global regulatory standards for financial and capital markets. We hope our comments will be helpful in your deliberations. If you have any questions, please do not hesitate to contact us.

Yours sincerely,

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Toshio Ando
Chairman