

The Director General delegate

Paris, October 15<sup>th</sup> 2008

**BCBS Consultation on « Guidelines for Computing Capital for Incremental Risk in the Trading Book » and on the “Proposed revisions to the Basel II market risk framework”**

Dear Sirs,

The French Banking Federation (FBF) welcomes the opportunity to comment on the BCBS consultations on **“Guidelines for Computing Capital for Incremental Risk in the Trading Book “and on the “Proposed revisions to the Basel II market risk framework”**.

The FBF thinks that the scope of IRC and the different risk factors should be more precisely defined especially for credit spreads and equity risks. If the Basel Committee is aiming at a wider scope, it should give more time for banks to devise corresponding models and to undertake the necessary tests in order to make sure that models are sufficiently robust. The IRC is in advance of market practices and will raise significant use issues for the front office departments.

The 2010 deadline for implementation is clearly too short even for a scope limited to credit products. We wonder how supervisors could validate internal models that are still under construction. We would strongly suggest a fallback option using a VaR multiplier as an alternative temporary solution. Modeling such matters is complex and requires substantial resources that are already consumed by the current market situation. If the scope of IRC intends to cover equity instruments, then it will be a project of even greater complexity demanding additional years for implementation.

Regarding the consultation paper on “the proposed revisions to the Basel II market risk framework”, we believe that the specifications of market risk factors are not fully in line with the Incremental Risk charge. Moreover, we urge banking supervisors not to impose prudential valuation principles that are not strictly in line with accounting standards. The Industry would strongly resist to such a bifurcated approach; it would not be manageable from both an information system and, more importantly, an intelligibility standpoints.

You will find our detailed answers in the annex attached.

**Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH – 4002 Basel**

The French Banking Federation is committed to building a level playing field that, we believe appropriate regulation can contribute to create. The FBF remains at the Basel Committee on Banking Supervision disposal for any further discussion on these issues.

Sincerely yours,

A handwritten signature in black ink, appearing to read 'Lauzun', with a stylized flourish extending to the right.

Pierre de Lauzun

## Response of the French Banking Federation

### Scope and coverage

The FBF thinks that the scope of IRC and the different risk factors should be more precisely defined especially for credit spreads and equity risks. We believe that the BCBS should only include instruments driven by credit risk factors. Equity risk factors should be treated apart in a separate consultation. If the BCBS wishes to consider a wider scope of risks, it should allow a longer period of time for banks to devise corresponding models and to undertake the necessary tests to make sure models are sufficiently robust.

**Question: 1.** Under the proposal, the IRC would reflect all price risks except those directly attributable to movements in commodity prices, foreign exchange rates, or the term structure of default-free interest rates (“non-IRB market factors”).

(a) Would it be preferable for supervisors to list specific types of events that must be captured (eg defaults, migrations, and only certain types of movements in credit spreads and equity prices)? What should be the basis for determining which types of events would be included, and how could the Committee ensure that the framework was not largely backward looking?

(b) Would it be worthwhile to expand the scope and coverage of the IRC to capture price risks associated with commodity prices, foreign exchange rates and the term structure of default-free interest rates?

#### **Answer: 1.**

(a): *A list of type of events that should be included in the calculation, as well as guidelines related to the minimum length of the history requested to define the price movements are necessary to avoid confusion. To avoid arbitrage opportunity with Basel II framework, it should be mentioned that parameters (default rates, migrations, extreme movements of Equity prices) are estimated over the cycle.*

(b): *We believe that the time frame given to banks in order to produce the IRC is too short to include all types of market risks.*

### General versus specific risks

**Question: 2.** For covered IRC positions, Pillar 1 charges would depend in various ways on Three types of risks: general market risks and specific risks, as defined under the current MRA, and IRC covered risks. Are the differences among these types of risks clear and measurable?

#### **Answer: 2.**

*The different risk parameters should be more clearly defined and distinguished. There is clear distinction between specific and general risk in Basel I Market risk framework. Putting IRC forward will redundant in some extent with VaR. The boundary between VaR and ICR should be clarified. In all cases risks should not be double counted.*

*No. We believe that the differences among these types of risks are not clear enough and measurable. Some (not exhaustive) issues are not totally clear:*

- Keeping the “diffusion” in the IRC
- Double counting of VaR Equity and credit and IRC
- Assumption used to define liquidity floors
- Netting intra-obligor
- For a bank that would mainly intervene in the Equity and Credit market, what would be the point in calculating a VaR in the MRA framework?

### Double-counting adjustments

**Question: 3.** While the capital horizons and confidence levels underlying the IRC and the 10-day VaR charge would differ, the risk factors captured by these risk measures would overlap to a significant degree. However, any adjustments to offset double-counting would complicate the framework and diminish the Pillar 1 importance of the 10-day VaR calculations including incentives to estimate the 10-day VaR as accurately as possible. Is it possible to provide double-counting adjustments that do not raise such concerns? How?

**Answer: 3.**

*Including the diffusion in the IRC process, results rise largely in double counting the diffusion aspects. The incentive to fine tune the VAR for the IRC factors will be low given that the horizon and the severity are both far lower in the VaR framework than the one suggested in the IRC. Moreover, the same portfolio could require more capital in a trading book than in a banking book with the rules mentioned in the guidelines, which is contrary to the management of risks in trading book.*

### Capital horizon and confidence level

**Question: 4.** The proposal stipulates that an IRC model incorporate a one-year capital horizon, a 99.9 percent confidence level, and a liquidity horizon appropriate for each trading position. The Committee recognises that such an approach could present considerable practical challenges, including the need for data to calibrate key parameters.

(a) What alternative guidelines would achieve the Committee’s objectives, but in a manner that would be less costly or difficult to implement?

(b) Given the current state of risk modelling, is it feasible to estimate the portfolio loss distribution (excluding non-IRC market factors) over a one-year capital horizon at a 99.9 percent confidence level?

(c) Would it be worthwhile to allow banks to use a single horizon for all covered positions (eg three months) and a lower confidence level (eg 99 percent), together with a supervisory scaling factor that was calibrated to achieve broad comparability with the IRB Framework for the banking book? Would such an approach be as useful for internal risk management purposes as the proposed IRC?

**Answer: 4.**

*This is one of the most complicated questions. There is no well recognised model developed by the industry to calculate capital requirements on a one year period for trading book*

transactions. Different models can lead to very different capital requirements according to the underlying exposures and to the different types of risk that may require different types of modelling. The 99.9% confidence interval is quite impossible to reach. With a one year constant level of risk, it will lose touch with reality. It will only be used to calculate capital requirements without any link to real life. We believe the main concern of better monitoring credit risks can be achieved through improvement to current VaR models.

- (a) *Excluding the issues raised by the diffusion of IRC factors over one year, we propose to include renewal hypothesis in the parameters, in order to reduce the calculation complexity, instead of developing multi-step framework. For example, for probability of default (resp. for rating migrations), it is possible to estimate probability of default (resp. for rating migrations) for the liquidity horizon based on historic averages. In some way, it can be said that there is an autocorrelation factor that make the transition process non-markovian, and that this property is included in the lower probability of default for three month horizon. To take a single period would have the advantage to be meaningful for risk management contrary to multi period indicators which are difficult to analyse and which appears not adapted to trading book.*
- (b) *For those currently using a historical VaR it means changing the whole process to a Monte Carlo approach. Excluding the diffusion aspects and taking into account remark in a), the challenge seems reasonable; mixing diffusion and jump like features as proposed is infinitely more complicated. However, the model risk linked to the estimation of a 99.9% quantile is huge and so this approach could lead to arbitrages.*
- (c) *This approach although attractive from an operational point of view does seem to pass the use test from a risk point of view. We consider that this alternative approach with one single period and one lower quantile is very interesting and will be more useful for risk management and more realistic as far as the implementation and the model risk are concerned. Banks should have the possibility to use this alternative approach, with the condition to integrate the risks mentioned in the guidelines and not taken into account in the VaR today.*

## Validation

**Question: 5.** Given the IRC soundness standard of a one year time horizon and 99.9<sup>th</sup> percentile loss, the Committee seeks comment on how the resulting risk measure might be validated quantitatively. For example, would it be reasonable to validate the underlying model at shorter horizons and/or at lower percentiles? If so, how might one ensure that the validation exercise is relevant for the one year 99.9<sup>th</sup> percentile standard? Also, would different aspects of the model likely require different validation approaches?

**Answer: 5.**

*We believe that there are not enough data to allow for a validation of a 99.9<sup>th</sup> percentile loss on a one year time horizon. No back testing can be done which prevent banks to devise robust models.*

**Question: 6.** The flexibility built into the proposed IRC potentially could make Pillar 1 charges for trading positions less comparable across banks. How might the framework ensure greater comparability without unduly limiting firms modelling choices? In particular, would it be productive to require banks to calculate risk measures for standardised test decks of trading portfolios, which could be used to compare model results across banks

**Answer: 6.**

*VaR calculations are currently difficult to compare across banks. By ensuring that the same ratings and parameters are used for Basel II on the banking book and on IRC, it should increase comparability across banks. The benchmarking on standardised portfolio can also be useful. However one can not conclude only with figures and definitions of portfolios, looking in details the models and the parameters is necessary. So we have some doubt about the feasibility of such a study.*

### Implementation timeline

**Question: 7.** Is the proposed implementation schedule feasible? If not, which IRC guidelines, and what specific types of positions or risk factors, are most problematic?

**Answer: 7.**

*The information systems rehearsal induced by such changes seems huge. Another problem is the definition of the events that are included in the PNL calculation. We still have a low visibility on the definition of "certain types of movements in Equity prices or spread", and we expect this point to be quite difficult. The second most difficult part is the renewal hypothesis for which we have proposed a simplification. Clarification on the liquidity horizon would be welcome. Regarding the equities, even their integration is in discussion and nothing is specified in the guidelines. The deadline is consequently particularly too short for them.*

### Disclosures

**Question: 8.** What additional Pillar 3 disclosures related to the IRC, or the trading book more broadly, would be helpful to market participants and contribute to market discipline?

**Answer: 8.**

*We agree that appropriate disclosures should be provided. However it is probably too early to define precisely what will be relevant for the market participants.*

### Interim treatment for re-securitisations

**Question: 9.** Paragraph 50 requires a capital charge for re-securitisations. This would start on 1 January 2009 and last until the IRC has been implemented for these positions. Would it be worthwhile to expand the scope of these positions to all securitisations?

**Answer: 9.**

No

*Other comments :*

1) *option to use a global model taken into account the risks mentioned in the guidelines without having to separate these risks should be mentioned.*

2) floors of liquidity horizons are not realistic for instance for equity and even for some CDS. Banks should define these horizons and demonstrate to their regulators that they are relevant.