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Subject NVB draft response on consultationdocument 'BCBS Guidelines for Computing Capital for Incremental Risk in the Trading Book'

The NVB welcomes the consultative document "Guidelines for Computing Capital for Incremental Risk in the Trading Book" of the Basel Committee on Banking Supervision (BCBS) and appreciates the principle based approach to the proposed guideline. Depending on the ultimate set of the proposed guidelines, it could however lead to an additional very complex and computational burdensome system. The NVB supports the response to BCBS consultation document of the IIF, ISDA and LIBA.

General Remarks

Implementation date
Realistic timelines are of great importance for the model–quality for computing capital for Incremental Risk in the Trading Book. The implementation is very challenging in terms of required resourcing, finding applicable software and achieving necessary computer power. In addition, time needs to be factored in for internal validation, a parallel run and to prepare and obtain supervisory approval. Furthermore, the NVB is worried to work on the credit migration part before the first of January 2010, that will likely immediately change when it becomes an integral part with credit spread risk before the first of January 2011.This involves double work / extra administrative burden) for the banking community.

Therefore, the NVB strongly pleads to implement Incremental Default Risk by January 2010 and to defer credit migration risk at least till 1 January 2011 (to be implemented together with credit spread risk and equity risk) and to alleviate the drawback of a delayed implementation by requiring financial institutions to:
- put an (informal) IRC approximation model for credit migration risk in place and show corresponding progress to the regulator during the transition period. The progress per the first January 2010 does not necessarily involve validation of the migration risk model or implementation of the full model at the first of January 2010.
- adequately capitalize credit migration risk under Pillar 2.

Double Counting
The NVB welcomes the possibility to adjust for double counting, since implementation of Incremental Risk Charge (IRC) in the trading book will certainly result in double counting of risks. This overlap of risks to be captured in the Value at Risk (VaR) and IRC model is difficult to assess in absence of an integrated VaR+IRC model. Therefore the NVB pleads for a clear definition of double counting before the implementation of IRC in practice. In order to support the regulator regarding the adjustment for double counting, the NVB gives a suggestion under question 3 in this document.

Incentive IRC model: negative impact on capital management Trading Book
The NVB strongly believes that the IRC model outcome should give an adequate reflection of the risk capital (compared to the risk capital in the banking books). However this may be questionable since the BCBS guidelines neglect:

A. Assessment of the name concentration. Banks will have in general less granular trading portfolios compared to the granularity of the banking books. Therefore, the NVB anticipates that the risk capital for the name concentration in the trading books is much higher than the risk capital for the name concentrations in the banking books.
B. The diversification with the banking book. The proposed guidelines for IRC neglect the diversification with IRB or with the non-IRC risk types as part of VaR. As a result, the outcomes will be conservative and the IRC capital does not give a good reflection of the true diversification within the institution as a whole.
C. An alternative capital horizon for positions, which have shown to remain liquid even during times of crisis, such as equity positions. The NVB is of the opinion that liquidity should be rewarded, whereas the constant level of risk assumption does not provide any benefits for these positions (see D below).
D. The NVB anticipates that the constant risk assumption effectively boils down to applying a liquidity horizon of one year for equity risk, spread risk and migration risk. We expect that the constant risk assumption only holds in case of contingent risk, like default risk. As a result, the gap between the IRC capital and the IRB capital for the banking books is expected to be small just for this reason.

The NVB is concerned that the current BCBS guideline could result in a capital requirement that exceeds IRB capital (as very initial calculations have shown without considering spread risk and the credit risk component of VaR). This could give an incentive to hold (trading) positions in the banking book, for which risk is not managed on a daily basis.

Floor for liquidity horizons
Where the liquidity horizon still plays a role, the proposed floors can give a lack of risk differentiation and deprives the incentive to invest in more liquid positions. In addition, the approach is not an adequate reflection of risk capital, as the more liquid positions will be floored. Therefore, the NVB suggests to leave out the floors and publish non binding guidance regarding the average liquidity horizons for the product categories.

Pro-cyclical approach
Banks may use actual Credit Default Swap (CDS) information to calibrate input parameters, like PD and LGD. As a result, the IRC capital will increase in case of a higher spreads or will decrease in case of lower spreads. However, this does not only give volatile capital requirements for the banking industry, but this can severe an economic crisis and may cause system risk, as explained below.

In case of higher spreads and thus higher capital, banks may need to close down positions due to a capital limit excess. The closing of positions can lead to a further increase of spreads and / or can lead to (severe) market illiquidity. In case of an increase of spreads, the capital will increase further, leading to a further closing of positions, etc. Further, in case of low spreads and thus low capital requirements, banks may take a lot of position whilst no limit excess takes place. In case that spreads widen, this can actually cause a crisis for the above described reasons.

In order to prevent this type of system risk, the NVB considers if additional guidelines regarding the usage of through-the-cycle information and the assessment of the input parameters would be helpful.

Accounting principles
The NVB would like to stress that alignment with existing accounting principles is of utmost importance in order to avoid multiple administrations and reconciliation difficulties.

IX. Specific issues where feedback is sought

Scope and coverage

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 (e.g. 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?

The NVB welcomes the allowed flexibility to determine their own specific type of events as part of the IRC framework. In this way, financial institutions are able to achieve consistency between the type of events covered for internal capital calculations and the types covered for regulatory capital calculations

In addition, the NVB believes that key considerations of the BCBS should be:

a. *the development of a roadmap to a target solution for the capital framework, but with realistic timelines, so that banks can anticipate future developments required, as well as*
b. *a thorough (re)view of the overall framework regarding the calculation of required capital for market risk in the trading book. In particular, the additional value of the VaR methodology for market risk calculations would diminish with the IRC implementation. The main question is whether the regulator envisions the replacement of VaR by IRC eventually or that both frameworks will still be in place on the long run. It is very important for the banking industry to know how to pursue with their internal risk management framework on the long run, which partly relates to the regulatory vision.*

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?

See above.

General versus specific risks
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?

Although the definition of the individual risk types is conceptually clear, the NVB questions if this is also true for a separate assessment of the individual risk types. The overlap between the risks to be captured in VaR and IRC is difficult to measure (see also our answer with regard to double counting in question 3).

Double-counting adjustments
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?

The NVB welcomes the possibility to adjust for double counting and pleads for a clear definition of double counting before the implementation of IRC in practice.

The NVB would like to remark that the calculation of the impact of double counting can only be done in case of an integrated VaR+IRC framework. In the absence of an integrated framework, rough assumptions are needed to assess the impact of double counting.

Technical approach for adjustment of double counting
*It is possible to offset double counting in terms of making an adjustment on the Incremental Event Risk and not so much on the VaR itself. In this way, there is still incentive for banks to manage risk on the basis of the VaR. The following formula gives an alternative approach. Though it follows some **rough assumptions**, which might need further study, we believe that it can be a helpful **starting point** in coming to a pragmatic approach for adjusting double counting.*

$$MRC = 3VaR(10d, 99\%) + [IRC(1y, 99.9\%) - IRC(1y, 99\%)]$$

This approach assumes that the factor 3 extrapolates the 10-day VaR to a one year horizon. Then, the 1-year 99% VaR already captures the credit movements on the 99th percentile. Therefore, this part should be deducted by means of subtracting the IRC on the 99th percentile.

Capital horizon and confidence level
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 recognizes 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?

The NVB believes that the calibration of key parameters for the proposed horizon and confidence level is a complex matter. In this regard the NVB would like to stress that realistic timelines for the implementation of IRC are of great importance for the quality of the model outcome.

The NVB welcomes the flexibility of the current regulation to use internal capital models (like EC) for the purpose of IRC capital calculation. We believe that the double counting solution can further align internal with regulatory capital calculations, leading to a less costly and less difficult way to establish effective risk management.

Alternative methods, that would be less costly to implement and closer to the day-to-day risk management, request institutions to take more explicitly the risk types included in the IRC into account in their measures for Economic Capital or to add capital on the basis of stress tests for the risk factors included in the IRC.

b. Given the current state of risk modeling, 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?

NVB would like to point out that the framework requires all risk factors to take into account. According to the Dutch experience modeling of the portfolio loss distribution a one-year capital horizon at a 99.9 percent confidence level can be difficult as a consequence of required availability of data, required validity test of the model and the required back testing regime (BCBS page 9, paragraph 39).

c. Would it be worthwhile to allow banks to use a single horizon for all covered positions (e.g. three months) and a lower confidence level (e.g. 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?

The NVB believes that the usage of a scaling factor can be very important for day-to-day risk management, as we can use this to steer on lower percentiles (e.g. 99%) and/or a shorter capital horizon. However the ***scaling factor should be calibrated by the banks own model on the basis of their own trading portfolio****, as the scaling factor can be very dependent on this. Further, a supervisory scaling factor that is used to capture all the types of events but just involves a multiplication of the IDRC of the bank can lead to severe underestimation of risk. For example, the default risk on the 99% percentile can easily be 0. Scaling this will give zero IRC risk.*

Validation

5. Given the IRC soundness standard of a one year time horizon and 99.9th 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?

The NVB believes that it is not very useful to validate the underlying model at shorter horizons and/or at lower percentiles, as it does not guarantee the validity of the model at longer horizons and/or higher percentiles.

If so, how might one ensure that the validation exercise is relevant for the one year 99.9th percentile standard? Also, would different aspects of the model likely require different validation approaches?

The NVB agrees with the BCBS that the IRC validation standards necessary have to differ from those applied to VaR models. Given the difficulties in back testing Incremental Risk Charge, because of the of scarcity relating data availability, the NVB would suggest to consider a validation of the model in terms of soundness of the model assumptions and input parameters. Further back testing we can apply to the input parameters.

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 modeling choices? In particular, would it be productive to require banks to calculate risk measures for standardized test decks of trading portfolios, which could be used to compare model results across banks.

The lack of comparability is an immediate result of the principle based regulation (versus the rules based regulation). The NVB assumes that the regulator took into account this drawback when deciding for the principle based approach. The application of standard test packs involves the usage of the same input to the banks models. However, a main part of the difference in results between banks will stem from deviating input. This difference is not identified by the standard test packs.

Furthermore, the standard test packs should only be applied if relevant to the portfolio of the banks, as models will be calibrated to these portfolios and not take into account risk factors with insignificant exposure. A deviation of a banks outcome to the average result would therefore have no bearings on the accuracy of the model for the banks own portfolio.

Implementation timeline

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

Realistic timelines are of great importance for the model–quality for computing capital for Incremental Risk in the Trading Book. The implementation is very challenging in terms of required resourcing, finding applicable software and achieving necessary computer power. In addition, time needs to be factored in for internal validation, a parallel run and to prepare and obtain supervisory approval.

The NVB strongly pleads defer additional implementations (credit migration risk and credit spread risk) at least till 1 January 2011 <u>and</u> to alleviate the drawback of a delayed implementation by requiring financial institutions to:

- *put an (informal) IRC approximation for credit migration risk in place* and show corresponding progress to the regulator *during the transition period* The progress per the first January 2010 does not necessarily involve validation of the migration risk model or implementation of the full model at the first of January 2010.
- *adequately capitalize credit migration risk under Pillar 2.*

Disclosures
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?

The NVB supports more transparency but not at all costs. Disclosures should only be made when relevant and material. Furthermore overlap and contradiction with other regulation and definitions should be avoided.

Interim treatment for re-securitisations
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?

The NVB would like to have a clear definition of re-securitizations. The NVB does not support an interim treatment for re-securitisation. As this would still require additional considerable efforts

Therefore, the NVB strongly recommends to adopt an interim solution for (re)securitization after the new regulation for the IRB-RBA risk weights for securitization is finalized. In this way, the industry can (partly) adopt the risk weights for the interim solution. This will result in better consistency between trading book- and banking book frameworks. Inconsistencies between those frameworks can lead to the wrong incentives to shift exposures from trading to banking books or vice versa. In this regard, the NVB also would like to stress that realistic timelines, for establishing the interim solution for IRC within the banks risk management (systems) after the final IRB regulation are of great importance for the model quality.