AUSTRALIAN BANKERS' ASSOCIATION INC.

AFMA

7 August 2012

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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Dear Committee,

Fundamental review of the trading book - consultative document

Please find attached the joint submission from the ABA and AFMA on the Committee's consultative document, *Fundamental review of the trading book*.

Yours sincerely,

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Submission

Joint ABA and AFMA response to the Fundamental Review of the Trading Book

Australian Bankers' Association

Australian Financial Markets Association

7 September

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1. Introduction

The Australian Bankers' Association (ABA) and Australian Financial Markets Association (AFMA), here after referred to as 'industry', welcome the opportunity to provide feedback on the Basel Committee's consultative document, *Fundamental Review of the Trading Book*. Industry is supportive of the Committee's ongoing commitment to reducing risks and increasing the resilience of the banking sector. Industry also supports the Committee's move to increase the consistency in reporting across jurisdictions.

The following comments are provided for the Committee's consideration.

2. Broad comments on consultative document

Industry appreciates the information and guidance provided in the consultative document. However, further detail in some areas, such as around the liquidity horizons and how they work, is required to allow for in-depth feedback. Given this, industry sees the need for ongoing refinement and development of the ideas proposed and would welcome another round of consultation as the Committee's thoughts are further developed.

Additionally, concerns are held about the general application of some measures. For example, the endogenous liquidity proposals are less appropriate in countries like Australia, with less complex trading books, compared to European or North American jurisdictions. While maintaining the goal of consistency in reporting across jurisdictions, the Committee must be mindful of the need for national discretion to accommodate for variations in national circumstances.

Industry notes that over the previous decade and a half, the emphasis on regulation has been to encourage banks to develop models that passed the "use test", thereby aligning the calculation of regulatory capital to internal risk management practices and encouraging better practice in risk measurement. Unfortunately, many of the proposed new metrics contain less useful management information, compared to those they are intended to replace and as such threaten to reverse this incentive. Boards and senior management may have more difficulty interpreting ES than VaR, and it is unclear to what degree these stakeholders will be able to interpret or use the standard method output or liquidity charges. In other words, the proposals will de-emphasise the conventional, and very sensible, "use-test" for accreditation. Banks that focus exclusively on producing regulatory risk management metrics will effectively experience a reduction in the risk management information available. Such an outcome should obviously be of concern to both industry and regulators.

Furthermore, intricate mappings for the standard method will, for example, compromise the Committee's aims of delivering a method which regulators can use as a benchmark.

3. Comments on specific questions raised in consultative document

Question 1:

Which boundary option do you believe would best address the weaknesses identified with the current boundary, whilst meeting the Committee's objectives?

Industry's preferred boundary option is the Trading Evidence Based Boundary, as this is very close to the current regime applied in Australia where policy requirements already severely curtail movement of positions between the banking book and trading book. Those same policy requirements limit the trading book to positions that are liquid, a fact that industry believes led to the minimal P/L impact experienced by trading books in Australia during the crisis. Based on this experience, industry suggests that strengthening the boundary to only allow liquid products with short term trading intent will allow banks to

continue to employ our current capital rules that work demonstrably well (in Australia's case) for liquid products, while saving up the more complicated rules for those products (predominantly credit products) for which the current approach is inadequate.

The alternative boundary approach proposed by the Committee locks the definition of the trading book to accounting treatment and presupposes that good accounting outcomes will lead to good risk management outcomes. This is an assumption that should be tested strenuously before being adopted. Notwithstanding this, the outsourcing of the oversight of the trading book boundary from national regulators to reporting accountants is not desirable. Further, this classification does not incentivise banks to keep their trading books liquid.

It is noted that a potential demerit of the Trading Evidence Based approach is the possibility of fair value instruments in the banking book managed under Pillar 2. Industry notes that in Australia, interest rate risks are managed under Pillar 1. Industry supports the wider application of this higher standard outside of Australia.

Finally, it is worth noting that if a liquidity crisis were to reoccur and some assets cease to trade (thus meaning that it is not possible to demonstrate evidence of trading) then under this approach transfer of these assets to banking book would still be necessary. This suggests the framework should incorporate some degree of flexibility to permit appropriate reclassification of positions in times of severe market stress, asset illiquidity or if they no longer meet the trading intent requirement, in addition to applying an increased capital charge to long-term (banking book) holds.

Question 2:

What are commenters' views on the likely operational constraints with the Committee's proposed approach to capturing market liquidity risk and how might these be best overcome?

Reiterating the point made above, industry does not view endogenous liquidity as problematic in Australia. Experience during the Global Financial Crisis supports this view, as does the rigour with which industry and APRA have managed those instruments permitted to be held in trading books. Indeed, a clear distinction needs to be made between countries such as Australia and New Zealand, and the larger, diverse markets of Europe and America.

The major concerns held by industry around the liquidity proposals are as follows:

- The proposals will be difficult to implement and burdensome to operate;
- The means of controlling the problem of double-counting liquidity remain unclear;
- Much of the output will be difficult to interpret and add little to useful risk management information;
- It is unclear how the proposals handle the cases where liquid hedges are used for illiquid underlying exposures;
- The bucketing may be too gross (i.e. would there be scope for an even shorter horizon bucket for risk factors such as FX which are very liquid, as well as perhaps a shorter overall maximum horizon?); and
- The proposals could be largely made redundant (or made to only apply to a small portion of the trading book) if the trading book were (materially) restricted to those products for which the VaR approach has been proven to work well.

Additionally industry has a number of concerns with options for applying risk factor shocks over longer and varying horizons:

- Option 1 – Historical or simulated long-horizon shocks: There is typically insufficient data available to support this option;
- Option 2 – Historical or simulated one-day shocks directly scaled up to each liquidity horizon: There is some merit in this approach;

- Option 3 – Historical or simulated one-day shocks with the aggregate risk measure scaled up to a unified weighted average liquidity horizon: There is some merit in this approach.

An alternative simple approach for the risk factor shocks would be a slight modification to option 3, whereby short term shocks (whether they be 1-day or 10-day shocks) are employed and a national regulator-determined weighted average liquidity horizon applied. In practice, this could include scaling up shocks or, for agreed horizons that are too long for such an approach, actual moves. This would allow the retention of the current 10-day period if, on average, this could be shown to be about the horizon of the book. This would represent a method that retains some of the simplicity of the current approach while affording the regulator with the flexibility to adjust the horizon based on the nature of the instruments that it is comfortable to allow into the trading book.

Industry also holds concerns around the potential jumps in liquidity premiums in the proposal. This is a new concept that will likely require completely new modelling methods, or could result in a perfunctory process, unless specified by the regulator.

In summary, a more complex set of model assumptions cannot be guaranteed to produce an outcome that is meaningful, manageable or conducive to effective risk management and capitalisation of trading book exposures. Given the vagaries and extremities of liquidity it seems more pragmatic to have a parsimonious and consistent approach within the model and to either manage the overall capital level exogenously (for example, by use of a scaling factor or multiplier on the result, such as the "3 times" factor currently applied or a regulator determined liquidity horizon), or by materially restricting the trading book to those products for which liquidity is not such a large factor.

Question 3:

What are commenters' views on the proposed regime to strengthen the relationship between the standardised and internal models-based approaches?

From a systems point of view, this probably is the change which will require the greatest amount of work for banks.

As the current arrangements are somewhat simplistic and punitive, the Committee's reform intentions are, to that extent, welcome. However, the new proposals may go too far in forsaking simplicity. They appear to have been over-engineered, and will ask much of banks that do not have the scale of operations for intricate mappings of exposures. Even more advanced banks will find the implementation onerous; this will ultimately divert valuable resources away from risk management activities that are of "use" to supporting a broad duplication of effort across both internal and standard methods. Indeed, the complexity of the new standard methods (with different calibrations/parameterisations for different markets) may render the benchmarking of exposures between banks more difficult than the Committee has envisaged.

Furthermore, the floor on the internal capital charge – expressed as a fraction of the standard method charge – will be one of the more important calibration exercises in bringing the proposals to fruition.

Finally, industry holds concerns that the proposals provide a disincentive to obtain internal model accreditation. It is Industry's view that there must remain a commercial advantage to achieving internal model accreditation in order to justify the costs of compliance. For those banks for which trading book activities are a small proportion of the overall business, providing only a marginal incentive to seeking accreditation in the face of greater and more complex compliance requirements will encourage banks to use internal models for internal risk management purposes only. This would be a perverse but logical outcome.

Question 4:

What are commenters' views on the Committee's proposed desk-level approach to achieve a more granular model approval process, including the implementation of this approach for banking book risk positions? Are there alternative classifications that might deliver the same objective?

Operationally supporting some desks under internal models and some under the standardised models will present challenges beyond the simple need to produce differing regulator returns per trading desk. Industry note that a variety of challenges exist with 'turning off' internal model approval at a desk level and 'turning on' the information needed to calculate under a standardised model approach.

Industry considers that the requirement to implement and maintain parallel approaches and to switch between them over time at a granular level represents a significant and enduring operational impost which lacks convincing benefit from the perspective of encouraging sound and effective risk management. There are other more effective ways to address the level of capitalisation of trading book exposures: industry encourages focus on the outputs, via scaling factors, rather than the risk of over-engineering the process.

While not preferred, instead of individual trading desks, an alternative classification that may deliver the same objective would be to use individual risk factor ES back tested versus hypothetical profit and loss to that risk factor. Such an approach could be designed to align with the Committee's goals of differing liquidity horizons and restricted diversification of risk factors. Reiterating the comments above, portfolios such as IR, FX and equity have proven to be 'VaR friendly'. More onerous solutions, such as different liquidity horizons/ES, are better reserved for those portfolios that have large credit positions.

Question 5:

What are commenters' views on the merits of the "direct" and "indirect" approaches to deliver the Committee's objectives of calibrating the framework to a period of significant financial stress?

Industry understands that the Committee's proposals have been designed to simplify the task of determining a stress period while also reducing the need for proxying risk factor histories as new markets and risk factors develop.

Industry is supportive of the idea to allow banks to determine the stress period based on dominant risk factors only, as this represents a potentially significant computational saving. Further to this, industry has a preference against the 'indirect method', due to the additional complication and computational demand that the scaling approach would represent. Industry believes that a certain amount of risk factor proxying is inevitable and that basing the ES calculation on a single period will assist keeping the model relatively simple and transparent.

On the other hand, industry acknowledges that the indirect approach requires the production of data (that is, the 1-day Expected Shortfall number) that could be useful for day-to-day internal risk management purposes and potentially also for back testing.

Question 6:

What are commenters' views on the merits of the desk-based and risk-factor-based aggregation mechanisms to deliver the Committee's objectives of constraining diversification benefits?

Given the committee's stated aim to limit diversification benefits, then the risk-factor-based approach appears to achieve this aim. Furthermore, this approach is an objective way for the aggregation of risks and is consistent in approach regardless of at which trading desk(s) in a bank those risk factors arise.

By comparison, the desk-based approach is subjective and in many cases the distinction between desks will not be clear – it is likely to generate the risk of a further range of "boundary" issues for regulators to oversee, on either side of which the capital outcome may vary materially. In addition to this, such an aggregation approach is likely to penalise macro hedging across the entire book, which would be an undesirable outcome.

Industry notes that one advantage of the desk-based approach is that it will facilitate back testing on a desk basis. For the risk-factor-based approach to work in conjunction with the Committee's ideas of desk-based accreditation and back-testing, then desk-based measures will still need to be defined and calculated by banks.

Question 7:

How can regulators ensure robust supervision of integrated market and credit risk modelling? In particular, how would an integrated modelling approach affect other elements of the proposed framework (eg the choice of the quantile parameter for ES, the P&L attribution and back testing processes, etc)?

While theoretically integrating market and credit risk should be feasible, industry recognises the difficulty of putting this into practice. Industry has no specific suggestions on this topic and recognises that in some cases there is value in separating the components to keep the framework simple, easy to understand and easy to manage.

Question 8:

What are the likely operational constraints with moving from VaR to ES, including any challenges in delivering robust back testing, and how might these be best overcome?

The operational constraints of moving from VaR to ES will depend very much on model implementation details that are not outlined in this current document. For example, changing a historical simulation VaR into a historical simulation ES can be as simple as reporting the average of the numbers beyond the 99th percentile, however it is not clear if this will be acceptable and if there will be need to do things such as use longer historical time windows and/or employ some form of extreme value theory to estimate the tails.

Regarding back testing, it would appear that the traditional back testing approach will not apply nor be able to provide much meaningful data, given the differing liquidity horizons feeding the model and the constraints on diversification – unless there will still be a requirement to compute 99% 1-day VaR for the purpose of comparing with P/L outcomes – which would decouple the back testing from capital adequacy. Industry would appreciate further details from the Committee on how back testing is proposed to be employed.

On ES generally, industry is concerned that it will be volatile. Although dropping the confidence threshold below 99% could act to stabilise the measure, tail observations are inherently volatile; data issues would potentially exacerbate this issue. For example, observations which have little or no economic content – such as unreliable broker quotes in the wings of volatility surfaces, or trading in illiquid futures – could render the ES estimates spurious.

A move from a 99% VaR measure for capital to one based on ES increases the reliance on tail data from the distribution. This could have the effect of increasing the dependency on the assumption that historic data is a good proxy for future events.

Furthermore, senior managers may have trouble using the new measures. The Committee's aim of including tail risk in the general market risk charge could more effectively be achieved by mandating fat-tail adjustments to the VaR (for example Cornish-Fisher expansions for parametric calculations) in firms

where this is not currently practised. It remains unclear what significant benefits ES would provide over the use of both 99% VaR and a comprehensive stress testing regime.

Question 9:

Which of the two approaches better meets the Committee's objectives for a revised standardised approach?

It is industry's view that, in the partial risk factor approach, splitting up instruments into their component risks by *MVi*, current market value (or mark-to-model value) of instrument *i,* is difficult.

Therefore, the sensitivities based approach (add up the sensitivity x regulatory factor across all risk types), that is the fuller risk factor approach, is preferred. It will allow banks to determine their own risk weights, but the set of risk factors will be prescribed.

Furthermore, it is not clear how correlations will be determined. Optimally these will be designed to reduce the amount of hedging which breaks down under stressed conditions. As recognised in the consultative document, different approaches are likely to produce vastly different outcomes.

Question 10:

Do commenters propose any amendments to these approaches?

In response to the above questions, a number of amendments have been suggested. In summary, these amendments are based on the following overarching observations:

- The trading book should be kept liquid. In that case, VaR has proven to be an effective tool;
- The creation of more onerous and complex methods is more appropriate for products with a concentrations of credit risk (and perhaps those with quite fat tails, such as some commodities); and
- ES has a weakness in that the results are even more dependent upon the history being a good proxy for the future.