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BCBS Consultative document regarding Fundamental review of the trading book

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representative of the entire Austrian banking industry, appreciates the possibility to comment on the document "Fundamental review of the trading book" and would like to submit the following position:

In general, the proposal aims to drastically change the current trading book regime at three major points. It starts with a redefinition of the trading book boundary, followed by a change of the model approval process and an overhaul of the standardised approach. It is expected that the overall operational burden will drastically increase and that the proposal will discourage certain model improvements (like modelling the spread risk "spezifisches Zinsrisiko"). All in all it can be expected that the future regime will be much more expensive especially in terms of regulatory capital and that the level of complexity will increase.

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

The trading evidence-based boundary appears more in line with current trading intent-based boundary and banks' core trading business models and risk management processes. We agree with the principle that the market risk capital charge should only capitalise changes in fair value having a direct impact on profit and loss and we are therefore in general supportive of a trading intent/trading evidence-based boundary.

If the Committee addresses market illiquidity risk as proposed, arbitrage problems as identified with the current boundary are likely to disappear and the result in the banking book will be more favourable from a regulatory capital perspective. While we understand the Committee's intention to design the boundary between the trading book and the banking book to be sufficiently robust to arbitrage, we are concerned that the proposal intends to make the boundary impermeable. In cases of substantial change in business model and/or risk management, the boundary should be permeable.

In the trading evidence based boundary, the trading book seems to be affected by minor changes, compared to the status quo and compared to the second approach, the valuation based boundary. To calculate any outcomes and becoming able to make a more detailed comment on the trading evidence based approach we would need to know how certain

positions, e.g. government bond positions, have to be treated. In general the approach would be consistent as long as the necessary proof for any asset classification does not get too complicated.

On the other hand the valuation based boundary would have a huge impact as it would mean that the trading book also includes FV and AfS positions in today's banking book.

We share most of the reservations mentioned in the document regarding a purely valuation-based boundary. On the one hand the decision concerning the classification is implicitly transferred to accounting standard setters. Furthermore as there is no unified international accounting framework which has to be applied by every institution in the world (and, in particular, to every entity within an internationally operating banking group), we see the possibility that institutions in different countries are treated differently. Examples are small banks and other non-listed institutions which use local GAAP for accounting purposes. At least, as mentioned by the BCBS, a valuation-based boundary would not align with existing internal risk management practices for trading activities. While such practices may of course be enhanced, this might be immanently difficult for positions e.g. in certain loans.

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?

The incorporation of the risk of market illiquidity in banks' regulatory capital requirements for trading portfolios would result in considerable costs and implementation/maintenance efforts and should be preceded by a thorough cost-benefit analysis. From an operational view, we agree with the proposal to base the differentiation of market liquidity across the trading book on the concept of liquidity horizon but suggest to apply it only to complex/structured credit products, not to standard financial instruments. The specification and supervision of the liquidity buckets is a practical issue that will have an impact on business. It is furthermore important to avoid double counting of market liquidity risk that is already captured via accounting valuation adjustments.

To avoid critical implications in the future different liquidity horizons should be included in the value at risk calculation. Positions shall be classified according to the market liquidity ranging from 10d to 1y. It is assumed that positions can be sold / hedged within this liquidity horizon.

We expect an increased complexity as for each position the liquidity horizon must be determined and stored in the system. It is also expected that these changed liquidity horizons will increase the capital requirement.

But we also want to address that at the moment it is not quite clear how the differing liquidity horizons will be used to derive the final capital charge. Finally it is not quite clear (three options are mentioned) how the different liquidity horizons will be incorporated into the risk measure. For example it can happen that in certain cases certain hedge relations are destroyed.

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

In general, the stronger relationship between the standardised approach and the internal model can be seen as positive with its potential to decrease certain imbalances in the treatment of positions in the standardised approach and the internal model approach.

However, the second proposal requiring mandatory calculation of the standardised approach by all banks implies considerable implementation and maintenance costs since risk management procedures based on the standardized approach are usually not maintained in

institutions that opted for the internal model approach. The back-stopping of regulatory capital calculations by a less risk sensitive standardized approach penalizes the financial, IT and human resources investments of banks that opted for more sophisticated internal models. The proposed introduction of floors based on the standardised approach (third proposal) disincentivizes banks to improve their risk management and their internal models. Instead of setting a floor based on the standardized approach, a mixture of standardized approach and internal model capital requirements would still give banks an incentive to use or apply the internal model method.

With the new requirements and the latest strengthening of the qualitative criteria internal models are no longer very interesting for banks because the capital requirements are in general higher than the current standard model. In conjunction with the higher capital requirements the qualitative criteria are punishing banks with internal models. The only advantage that remains is that the economical risk and the regulatory risk calculation are aligned.

We would suggest the improvement of the market internal model framework by a more layered approach that sufficiently takes into account the size and the complexity of trading books and gives more incentives in regard to capital requirements for more sophistication in internal model developments.

In general, we would like to warn that the loss of incentives for internal models could go along with a reduced standard of risk management and thus could be a step backwards. Especially, the possible floor (footnoted 80% of the standardised approach) could mean that future improvements of the internal models could be impeded.

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?

While there are some merits in an increased flexibility of internal model approval, the proposed desk-level approach would severely impact the capital planning for the trading book given the increase in uncertainty on regulatory capital figures if approved models may be turned-off for specific trading desks more easily than at present. If implemented as proposed, the organisational structure of trading desks is likely to become a strategic driver from a capital perspective.

We think that models should not be revoked abruptly but only after a grace period for correction expired. Instead of switching-off the internal model for trading desks not meeting the requirements, a weighted average of capital calculation under the internal model and standard rules could be considered smoothening the passage to standard rules. Furthermore, there should be more flexibility for banks to switch off parts of the internal model if the business model changes.

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?

We would like to mention that among the alternatives proposed in the consultation paper, we prefer the indirect approach to the calibration of the expected shortfall measure to a stressed period. This approach facilitates the fulfillment of the use test requirements and the embedment of the risk measures into the trading strategy and processes of banks.

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?

We are concerned that the proposed approach to constrain diversification benefits could discourage banks from pursuing a diversified business model and result in potentially wrong hedging incentives due to pre-imposed correlations across risk classes, thereby increasing, rather than reducing, systemic risk.

7. How can regulators ensure robust supervision of integrated market and credit risks 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 backtesting processes, etc)?

From a pure risk perspective, we are in favour of an integrated market and credit risk modelling approach which would decrease the overlap between various measures of the Basel 2.5 framework. We are, however, hesitant to support regulatory requirements for such a model as banks could not leverage the investments made for the Basel 2.5 implementation regarding IRC and CRM.

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

Back testing the ES measure is more challenging than back testing VaR, as formal tests for the ES measure would be a joint test of the accuracy of VaR and the expectation beyond VaR. We suggest to consider a lower percentile as a more appropriate threshold to calculate the ES measure (95th percentile instead of 99th percentile).

At the moment it is not clear which confidence level will be chosen. For that reason it is difficult to estimate the possible impact. In case the confidence level is not changed it is expected that capital requirement for the trading book will jump. Therefore it is preferred to lower the confidence level so that for an average bank the capital requirement stays the same which would be a consistent procedure compared to the enabled transition period for the credit risk in the transition from Basel I to Basel II.

In general an adaptation of the relevant confidence level in such a way would be necessary to ensure methodological stability, comparability and consistency of risk calculations and results over time.

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

First of all both approaches (partial & fuller risk factor approach) would cause problems to implement for smaller banks with a trading book, as significant implementation efforts would be necessary.

However, it can be seen as a positive detail that the standardised approach will become a credible alternative to the internal model approach combined with the point to become more risk sensitive (i.e. certain hedging relations should be better captured). It is mentioned in the proposal that the risk weights should be calibrated to stress periods. Which potential implications this approach would mean to capital requirement cannot be assessed at the current stage due to the fact that the standardised approach will be redesigned. Clearer descriptions of potential changes are necessary.

The partial approach is simple, however, heavily relies on very special and unrealistic assumptions. The basic elements of the buckets under the partial risk approach seem to be rather similar to the existing risk categories. What is new is to capture additionally correlations between risk categories or buckets leading to a more sophisticated own funds calculation. The question is if this justifies the enormous investments the banks have to make in order to implement the new approach.

The full factor approach is probably preferable, but still remains complex, not fully coherent and in our view inferior to a well designed internal approach. The full factor approach is half way to a small internal model from the implementation effort.

Small and medium-sized credit institutions in Austria take the view that there should be a possibility to retain the current standard approach under certain circumstances. Those criteria should be based on the size and complexity of the trading activities (Proportionality).

In general details of position splitting and netting/hedging need to be clarified.

The document states that for comparing different banks the revised standardized approach can be used. This argument has to be rejected because of the current non-clearness for both approaches the comparability is rather limited. We would suggest to use plain sensitivities (BPV, Deltas, Gammas) per asset category for comparing different sizes of trading books. This is market standard.

Moreover, we would like to state the following in regard to the revised models-based approach:

There are three major changes in the models-based approach which potentially will have a huge impact on different aspects.

Firstly the approval process would become much more complex. Furthermore, the analysis concerning the modelable risk factors is going to be more demanding than it is at the moment. It is expected that results must be available at a much more granular level than it is the case at the moment. Finally the way regulatory capital is calculated will change. Under the proposed regime the risk measure is calculated for each risk factor separately. In a second step the individual risk measures are aggregated with pre-determined correlation parameters. The potential outcomes are certain diversification effects which will be reduced and would result in higher capital charges.

For a not only nowadays well-balanced trading book (i.e. a trading book without huge dominating risk positions) this effect can be quite dramatic. From our point of view it cannot be the intension of the legislator to penalise in particular low risk bearing trading books.

10. Do commenters propose any amendments to these approaches?

Both approaches should be properly and conservatively calibrated. A QIS should be conducted to assess the impact and identify areas for refinement.

Finally, we would like to submit one general remark. As capital charges derived from internal models should cover losses in stressed market periods the document states that models should be calibrated to stress periods. We understand the proposal in that sense that it is planned to drop a value at risk calibrated for non-stress periods and in addition it becomes calibrated only to stress periods. In general this is positive as double counting will be eliminated and the calibration and calculation will be more transparent.

Kindly give our remarks due consideration.

Yours sincerely,

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