

RE: Fundamental Review of the Trading Book. (Consultative Document – May 2012)

Dear Committee Members:

BBVA welcomes the opportunity to provide feedback on the consultative document of reference. This letter covers our views about the review and the specific questions included in the consultative document. These views are generally aligned with the ones included in the answer of the European Banking Federation that we support.

General comment

After the recent reforms in the rules included in what is known as Basel II.5 BBVA shares the need for a fundamental review of the trading book with the objective of a more consistent and robust framework for measuring the regulatory capital required in the trading activities eliminating some well-known duplicities and enhancing some limitations of the current rules.

Being this a fundamental review, a proper timing for the calibration of the final rules and its implementation should be designed. The analysis of the impact should be carefully assessed in order to ensure that the new framework for market risk is commensurate with the inherent risk of the trading portfolios. Additionally, this review should leverage current risk management practices and infrastructures.

Answers to the specific questions.

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

We consider that the trading-evidence based approach should be the base criteria to define the perimeter of the trading book rules. This option ensures coherency with the way that inherent risks are managed and avoids any link to accounting standards that can cause significant asymmetries. Moreover, the use a perimeter based in accountancy criteria (option 2) could have non contemplated effects over positions included in the DPVs portfolios such as positions in government bonds in these portfolios which are used as a natural hedge for interest rate risk in the banking book and by the inclusion in the scope of these rules can result penalized in terms of capital.

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

We support that the liquidity of the risk factors must be assessed when measuring capital for the Trading Book. However, working with many different liquidity horizons would make it difficult to calculate a coherent measure of capital and, additionally to backtest the results of the capital model. From our point of view, the number of liquidity horizons should be as low as possible and, once the trading-evidence based criteria would be needed (given this as the definitive option) to include a position in the scope of the rules, the possibility of a 1 year liquidity horizon seems to be unnecessary penalizing.

In order to deal with different liquidity horizons when computing the regulatory market risk metric, we think that the preferable option is to use a historical or simulated one-day shocks with the aggregate risk measure scaled up to a unified weighted-average liquidity horizon.

The use of one-day shocks as a base allows for a coherent measurement of risks, therefore we consider one-day shocks should be the base of the backtesting of the model.

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

We support the need for a review of the standardized rules as well as to strengthen the relationship between them and the internal models based approach in order to enhance the risk sensitivity of the standardized rules and to serve as a credible fallback option. Additionally, its use could provide an extra source of a homogeneous comparison of metrics between institutions.

However we would like to highlight that,

- Incentives in terms of reduction of capital to the development and use of internal models should be ensured.
- No floor should be applied to an internal model once it is approved by the relevant regulator.
- More clarification about how the standardized approach would be calibrated is needed. A risk sensitivity stressed calibration by factors/geographies to the most recent stressed historical data could lead to future capital measurements that penalizes certain instruments or geographies currently exposed to what are considered as exceptional circumstances and thus generating asymmetries between future capital requirements in different geographies, once these environment is overcome. Apart from this consideration, we consider that a mechanism of future re-calibration of the standardized method should be established.
- For banks with approval for the use of an internal model, the requirement of computing capital according to the standardized rules adds extra costs of implementation and maintenance, not only in terms of systems but also in terms of human resources. A balanced frequency of the requirement of the parallel computation according to the standardized rules should be established.

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?

We reckon the advantages of a more granular model approval process. However, breaking the modelling and establishing an aggregation mechanism have as consequence the loss of consistency of the modelling. Factors such as how different the desk structures of banks are, or change over time, and the mapping of instruments/risk to a desk can lead to asymmetries in the capital charges.

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 consider that the requirements in terms of data and computation in the direct method lead to a very limited probability of applying it. Thus we consider that an indirect method is needed. We support the proposal contained in EBF proposal that leverages a measurement based in most recent historical data that would probably continue to be used by institutions in their risk management policies.

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?

As we mention in question 4, the desk-based and an aggregation mechanism based on pre-established correlations has, as an immediate consequence, the risk of losing the consistency of the modelling and, thus, of the capital measurement.

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 backtesting processes, etc)?

Ideally, market and credit risk modelling should be integrated trying to avoid any double-counting of risks and taking into account correlations between them. An agreement about the confidence level and hypothesis of rebalancing the portfolio should be made (given the current discrepancies for the measurement of both risks). However we think that this modelling is very challenging. Additionally, the new requirements introduced in this review: P&L attribution, more granular backtesting process adds additional challenges.

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?

The main constraints are a robust backtesting of this specific metric and its possible instabilities depending on the size and composition of the portfolio.

First of all, in case of moving from VaR to ES, the confidence level should be lowered to avoid an artificial increase in the level of capital. Apart from the consideration of the confidence level, we support the use of the backtesting of some (e.g. two) different confidence levels as a proxy for the backtesting of the capital measurement based on ES. The mechanism of penalizing capital in terms of the result of the backtesting should also be reviewed and we consider that the rationale behind this future mechanism should be transparent.

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

A balance between the feasibility of computation for all financial institutions and risk sensitivity move us to consider the Partial Risk Factor as the general approach.