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Basel Committee on Banking Supervision
via e-mail: baselcommittee@bis.org

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Regards: NVB Reaction to bcbs 219 Fundamental review of the trading book

Dear Sir, Madam,

On behalf of the Dutch Banking Association[1] (NVB), I would like to thank you for giving us the opportunity to provide you with our feedback on consultation paper 219, '*Fundamental review of the trading book*'. The consultation paper forms the basis of a longer process of revising the prudential requirements for the trading book. As the framework has been partially modified since its introduction, the relation between the various approaches is not always logical anymore. We welcome the review the Basel Committee is undertaking. The NVB supports the response provided by the European Banking Federation; this letter highlights the key concerns of the Dutch sector.

This being said, we also note some implicit requirements that could unduly increase the operational burden on banks, such as the potential simulation requirements as well as explicit requirement to perform full revaluation of portfolios. Unfortunately, the scope of the fundamental review does not include the credit risk domain. As a consequence, the current inconsistencies between the various risk types, such as CVA, will not be addressed. We request the Basel Committee to increase (in due course) the scope of the review to include credit risk for the trading book. Last but not least, the actual impact and workability of the proposed framework in practice will depend largely on the calibration and granularity of the proposals. This underlines the importance of the anticipated QIS exercise, which is an integral part of this exercise.

In case you have any questions or remarks based on our reply, please feel free to contact me at your convenience.

Kind regards,

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[1] The Nederlandse Vereniging van Banken (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

Timelines
The question is when the new proposals should be embedded. As it is important to determine the impact of the proposals (i.e. an impact analyses and a consideration of the impact on systems), we support conducting a QIS study in 2013 and note that some elements will be easier to implement in a QIS format than others. For example, for banks that currently use the standardised approach, it might be quite a burden to implement the fuller approach. We therefore advocate using sufficiently long timelines, with a QIS taking part in the later part of 2013. We expect the QIS will result in valuable insights, which will add value to both regulators as well as the industry. In order to realise the maximum added value, regulators should also be available to answer questions from the industry that will surely arise. Despite the serious effort that is expected, we believe the QIS will provide valuable insights to the FRTB work stream.

Trading book/banking book boundary
We prefer the trading evidence boundary, but this should be practical and there should be criteria for the boundary. The CRD 4 already contains descriptions for inclusion in the trading book. New regulation should aim to make these more practical and to avoid unnecessary burden of proof in case of activities which should clearly be part of the trading book. Assessment should not take place on individual instruments and positions but on broad ranges on activities and instruments. Moreover as with liquidity, focus should be on the way risks are managed. Furthermore these criteria should allow for products that become temporarily illiquid due to market circumstances to stay in the trading book.

Further, disadvantages of the valuation based boundary are as follows:

- There are differences between countries in the 'valuation based' boundary due to the dependency on accounting standards. This contradicts the main objective of Basel regarding the establishment of a level playing field and can be considered a very serious drawback.
- Available for sale books generally have a longer horizon and risk in these books is managed differently. If treated under a trading framework entire books should be included, including liabilities and funding, and not only the fair valued assets, which would in practice mean that a strict boundary cannot be maintained. It would be preferable to address issues with available for sale books within the banking book in a general interest rate for the banking book framework.

Moving from value at risk to expected shortfall
The NVB understands the desire of regulators to introduce the expected shortfall in order to better incorporate 'fat tails'. However, we would like to share a number observations about VaR:

- The VaR worked properly for the main portfolios, as tail risk is not a major issue for books with limited optionality. Dutch banks do not have big issues in regards to the performance of the VaR calculation; even during the crisis, only a limited number of outliers was reported.
- First investigations show that the ES is generally a fixed multiple of the VaR for portfolios with limited optionality, so the additional added value of moving to ES is limited.

The introduction of the expected shortfall as well as the longer liquidity horizons will increase the incorporation of fat tails into the regulatory requirements. As a result (and depending on the final calibration), it could be expected that the added value of back-testing will decrease given the lower number of expected outliers. We expect the regulation to set clear criteria regarding the back testing based on the new stressed ES measure.
If the choice would be made to move to ES, it should be made as practical as possible. For banks using historical simulation, a relatively small number of tail scenarios is available. Banks should be allowed to keep the current methodology and current system set-up. This can, for instance, be established by setting the threshold of ES to a lower confidence level (e.g. 95%) and to use simple assumptions to include poor liquidity (e.g. capital add-ons for any product or risk factor with poor liquidity instead of trying to model these with long horizons). If banks would be required to move away from historical simulation and/or add more complex features to the models, the required

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changes to systems will be substantial. The investments could become disproportionate to the added value achieved by moving to ES.

Incorporation of an assessment of liquidity.
Banks should be allowed to model their own liquidity horizons, under supervisory review and approval. We suggest the Basel Committee come up with clear methodological guidance in this area, allowing banks to resolve the challenges that are associated with the requirement to model liquidity horizons, thus safeguarding the level playing field. Additionally, we recommend to allow banks that are either unable to model the liquidity horizon for certain products or sub-portfolio's, as well as for banks that have a relatively small trading book, to use standard liquidity horizons per product group. These horizons should be specified by the regulator in cooperation with the industry.

Treatment of hedging, diversification and desk level validation
The NVB supports the joint reaction of the IIF, ISDA, GFMA and TCH in this area. Fixed regulatory correlations can hardly be determined, as these depend on portfolio composition and it is not clear how to allocate one product to the various risk categories.
This being said, we also acknowledge that there can be large offsetting effects in the VaR, that could reverse, leading to losses that are not reflected in the VaR. Therefore we support the proposal to give a potential reduction of the existing diversification effects dependent on model performance, P&L attribution and following the comparison of the outcomes across banks.

Standardised approach
The Basel Committee intends to make the standardised approach a credible fall back option for IMA banks. Simultaneously, SA should be simple enough to allow banks with relatively small trading portfolios to use it as the primary model. There is a trade off to be made between simplicity and risk sensitivity.
As there might be a requirement for IMA banks to calculate standardised results, we are concerned that the introduction of this fall back (which is to be used in case of performance issues of the internal model) can lead to extensive system requirements. IMA banks should focus on maintaining and improving their internal models. This is especially the case if there are flaws in the model or in situations where too many outliers were observed for the total portfolio or on desk level. Having to focus on the standardised approach in such situations would not give the right incentive to improve internal models and it would reduce the availability of valuable time and resources required for proper management of risks.
Also, suspension of the IMA license for a certain desk could impact macro hedges the bank applies at a more aggregated level, impacting the overall risk numbers. Striving for a conservative approach to risk is good, but a too conservative approach will limit banks in their core business of providing financial services to their clients. In cases where deficiencies are discovered, capital add-ons should be imposed immediately as a pillar 2 measure until the issues are addressed to the satisfaction of the competent authority. The same goes for the introduction of a floor based on standardised capital that will disable effective risk management and proper decision making, especially if the standardised approach would be set conservatively. In this regard, it is also important that the methods used to test model effectiveness, such as back testing and P&L attribution, should not be set too rigidly. For instance, if a bank chose a conservative approach in its risk model, it could find differences in its P&L attribution. The different methodologies that are used between finance and risk should not result in conservative modelling being penalised.

If the standardised approach is imposed on banks with an internal model, we prefer to implement the fuller approach, as it better aligns with availability of information in the trading risk infrastructure. Alternatively, the partial approach could be adjusted to also make use of sensitivities to risk factors. Banks that have a trading book generally monitor sensitivities to risk factors on an on going basis, whereas mapping market values of individual instruments to buckets and/or splitting instruments in more elementary values (such as cash flows) can require a significant change in infrastructure.

Although the calibration has not been set yet, internal models in their nature should be less conservative in their estimations, as a result of the natural layers of conservatism that are included in the standardised approach. We appreciate the regulator seeking a level playing field, however the standardised method can hardly be used as the benchmark, given the fact that products can vary significantly across different countries. For instance, in the banking book there are very different products in the mortgage market across countries that are not always reflected in the standardised approach. The same reasoning, although to a lesser extent, also applies to the trading book. We therefore believe the execution of an SA calculation might not add value to IMA banks. If the regulator still opts for this requirement, care should be taken to make the application of the parallel run requirement as practical as possible, limiting the operational burden on IMA banks, as it might not add much value. We therefore suggest a required frequency of not more than twice a year. If a bank desires to increase the number of parallel runs on a voluntary basis for its own risk management purposes, this should be allowed.

Full revaluation
We note that full revaluation for all products in the trading book could create a large burden on banks' systems, while we expect full revaluation will only have a significant impact on non-linear portfolios. We therefore propose the introduction of a waiver for linear products. In order for the waiver to be granted, the bank would have to regularly demonstrate - to the satisfaction of the regulator - that full revaluation provides immaterial differences.

Appropriate treatment of Credit
Although the VaR and/or ES measures do not explicitly cover migration and default risk, these risk types should be carefully considered to avoid duplication of risk.

We recommended that further impact analysis is done to:
1. Compare the outcomes with the current IRC outcomes and;
2. Compare the outcomes with the Banking Book results for similar positions.

Depending on the final settings of the new market risk model, it could be concluded that IRC might not be required anymore. This is due to the fact that credit migration risk is already captured in the expected shortfall, especially when taking into account the proposed stressed period and longer liquidity horizons. It could well be that the required levels of capital for positions with credit risk in the new framework will be sufficient *and* in line with the banking book. If IRC is going to be maintained, its capital horizon should be brought in line with the proposed framework, i.e. capitalisation for one liquidity horizon and no rolling over.