

*Set up in 1960, the European Banking Federation is the voice of the European banking sector (European Union & European Free Trade Association countries). The EBF represents the interests of some 5000 European banks: large and small, wholesale and retail, local and cross-border financial institutions.*

*The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.*

**Subject :** Final EBF response to the BCBS consultation on the fundamental review of the trading book

## General remarks

The EBF welcomes the opportunity to share with the Basel Committee (BCBS) the views of the European banking sector on the consultative document about the fundamental review of the trading book (FRTB).

The EBF considers this an integral part of the regulatory reform that needs to be carefully designed in order to preserve the merits of the background systems and infrastructure that supports the trading book business whilst overcoming the problems that have become apparent during the crisis.

We understand and welcome the Committee's objective to seek a more consistent framework for trading book risk. On the other hand, the cost of implementation and operation of the new models proposed also need to be taken into account.

The EBF recommends that the new framework should be based upon the following pillars:

- The use of a trading-evidence boundary.
- The alignment between the models used for capital and those used for risk management.
- The availability of a simple standardised approach like the partial approach proposed herewith.
- The use of the standardised calculations for large banks only as a benchmark on a half-yearly basis.

It would be of the essence to conduct a quantitative impact analysis (QIS) before determining the final rules. However, given that the current proposal remains at a high-level we suggest launching a second consultation on specific rules (using scenarios if needed) before carrying out the QIS.

## 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?***

- The trading-evidence based approach is the preferred option by the majority of the European banks, though it should be subject to certain conditions:
  - The proof should be tangible and auditable but the operational implementation should remain reasonably feasible.
  - Reclassification should be allowed under exceptional circumstances in accordance with changes in the banks' business strategy or upon Regulators' requests.
  - Rather than the concept of 'instrument' it is more relevant how the inherent risks are managed.
- The merits of the trading-evidence approach over the valuation approach include the following:
  - It is more transparent, workable and coherent with the managed trading portfolio.
  - It is more straightforward and helps to link the outcome with the use test.
  - Classifying risks according to their nature, and assuming they are managed accordingly, is the most efficient way to ensure their adequate capitalization.
  - It calls for stronger governance which will promote sound risk management.
  - It is all the more affordable for smaller banks, because the valuation-based approach would entail that a wider range of transactions would be under the new (more complex) framework.
  - By and large, implementation costs, notably those related to infrastructure and operations, would be lower in the evidence-based approach.
- In turn, the main shortcomings of the valuation-based approach are the following:
  - Significant differences due to accounting standards.
  - Uncertainty about the scope of instruments to be fair valued.
  - Unintended consequences in the available-for-sale portfolio, notably government bonds, which could be exacerbated under the valuation-based boundary.
  - Due to the current review of the accounting framework, until the perimeter of the financial instruments which will be fair valued is not clear, it is not possible to check all

the potential inconsistencies that the “valuation-based” trading book boundary could entail. Moreover, the adoption of the valuation-based boundary would give rise to serious level playing field concerns, due to the differences in accounting among different jurisdictions.

- One particular case of concern about the misalignment of risk practices and accounting standards under the valuation-based approach is the link between the value of the loans and the traded bonds that fund the loans (e.g. Danish mortgage lending<sup>1</sup>).

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

- The European banking industry is generally supportive of the proposal for the management of liquidity horizons as a matter of principle, albeit some considerations should be observed:
  - In principle, the number of liquidity horizons used should be kept as low as possible, for instance one per asset class. Liquidity horizons should be linked to risk factors as this is practically the way risk is managed. Derivative instruments would (even in case of liquidation) not be sold as individual instruments, but as portfolios of risk factors which market parties could bid on. Risk factors that show low liquidity levels -such as the volatility skew and implied correlations- could be incorporated based on an add-on or via conservative proxies. The Committee proposed approach, under which the liquidity horizon assigned to the risk factor is determined as the longest liquidity horizon among those of the traded instrument from which the risk factor is derived, could lead to inconsistencies if the definition of risk factors become too broad. This is because risks could not be aggregated across products. This would entail that a possibly very small but longer dated risk exposure could drive the capital charge for the whole portfolio. For instance, two risk positions mapped to the same risk factor, but linked to financial instruments with different liquidity profiles, would be associated to the same liquidity horizon (the one of the less liquid instrument). This approach would penalise liquid instruments, introducing arbitrage opportunities. We therefore seek clarity from the Basel Committee on the definition of risk factor to ensure that such a situation could not arise.

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<sup>1</sup> In the IAS 39 (9), “Definitions of four categories of financial instruments” point (b) (i) it is stated that a financial instrument can be designated at fair value *if it eliminates or significantly reduces a measurement or recognition inconsistency (sometimes referred to as “an accounting mismatch”) that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases*. If the fair value designation of a financial instrument is due to this concern of avoiding accounting mismatch, the financial instrument should not be included in the trading book.

- There should be flexibility for banks in the determination of liquidity horizons under due supervisory approval. There is need for some judgment also to handle regional and national particularities as one model does not fit all. The significant increase in the capital requirement for mid-sized institutions should be considered, as they work in a regional/national market and with national sovereign and corporate issues due to the incorporation of the ‘endogenous’ liquidity aspect. This could have adverse effects for certain markets (e.g. Nordic sovereign market) even leading to higher funding costs for sovereign and corporate issuers. The increased funding cost could reduce the liquidity in the market, feeding a vicious circle. The Committee could put forward methodological guidance that would help banks to overcome the challenges associated with the requirement to model liquidity horizons whilst ensuring that the level playing field is safeguarded.
- In the particular case of smaller banks, we recommend to allow banks that are either unable to model the liquidity horizon for certain products or sub-portfolios, as well as for banks that have a relatively small trading book, to use standard liquidity horizons by product group. These horizons should be specified by the regulator in cooperation with the industry.
- Regarding the three options proposed by the Committee for implementing this approach:
  - The first one consists in using historical or simulated long-horizon shocks. This approach of historical or simulated long-horizon shocks would require extensive simulations together with a rebalancing of hedges up to the risk factor liquidity horizon. It is very complex and not all the institutions using internal models will be in a position to implement it.
  - The second option consists in scaling up historical or simulated one-day shocks to each liquidity horizon. This depends on a square root of time scaling using different horizons for different factors depending on its liquidity horizon bucket. This result would again not respect the correlation structure of risk factors across time and could lead to unrealistic shifts in case of long liquidity horizons combined with stressed market movements (simple example: a large daily loss on a cash equity could scale up to a loss larger than 100%).
  - The third one consists in scaling up the aggregate risk measure that is based on historical or simulated one-day shocks to a unified weighted-average liquidity horizon. This approach allows using 1- day correlations in a consistent fashion but then assumes the same correlations apply across longer horizons. In addition, using a weighted average liquidity horizon is not necessarily meaningful and would not provide a capital allocation that is proportional to risks. Back-testing considerations must also be taken into account and only option 3, which keeps the 1-day measure, would allow to fulfill back-testing requirements. However, scaling 1-day risk measures to a longer horizon, will not be a

correct reflection of the risk for a non-linear portfolio. The discrepancy will become larger with increasing liquidity horizons.

All in all, the third option, i.e. the unified weighted-average liquidity horizon, would be preferable.

- Alternatively, it was discussed at the meeting of the Trading Book Group in Washington to introduce the liquidity horizon adjustments in a “prudent valuation” framework. This would be in continuation of the Basel 2.5 framework and could leverage on the work currently undertaken by the EBA on the matter. This being said, regulators must beware of the perverse effects of imposing unreasonably prudent valuation as this could materially bias risks and hedging. Consequently, should such approach be retained, we believe the use of a unique liquidity horizon for the Expected Shortfall in combination with a separate capital add-on accounting for exit costs would be preferable. Such capital add-on would reflect the bid/ask spread of exiting a position within a given liquidity horizon in stressed markets as well as the jumps in liquidity premium as specified in the consultative paper.
- In any case, a quantitative impact study would be needed to properly assess the impact of implementing liquidity horizons. Impact analysis should compare the results against the current incremental risk charge outcomes and also against the outcomes of similar positions in the banking book.

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

- The EBF acknowledges that the calculation under standardised approach enables a more straightforward comparison between institutions and that it could also be used as a contingency plan. However, these observations should be regarded:
  - Simultaneous calculations under both approaches, standard and internal, will be burdensome. The costs of compliance should be assessed and kept at a minimum.
  - The incentives to develop internal models should be carefully assessed as well.
- The EBF sustains that the standardised approach should meet 3 objectives:
  - To provide larger banks with a fallback solution that is enough advanced, i.e. risk sensitive.
  - To permit smaller banks a simple implementation.
  - To keep the overall cost under control.
- To this end, the EBF proposes that:
  - The standardised model should not be used as a floor to the internal model outcomes but only as a benchmark.
  - The calculation under standardised model should only be run twice a year.

Whatever the case, it needs to be taken into account that the introduction of the standardised approach calculation requirement can lead to extensive system requirements. It could also distract the teams in charge from the maintenance and improvement of their models. We are of the opinion that this requirement should be made as practical as possible, i.e. without imposing a heavy operational burden on banks, as it would not add any value to IMA<sup>2</sup> banks.

***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 support that it may be practical for non-IMA banks to apply for a granular implementation of Internal Models. This diminishes the challenges and would probably promote banks to strive for IMA. This is however not the same as having approvals switched on and off. Basically, it can be assumed that the whole range of approved IMA models within a bank remains under this regime to retain the consistency within a bank's approach.
- The desk-level approach could streamline the supervisors' work but at the expense of losing uniformity and consistency with the internal model of the bank. For example, the same financial instrument could be subject to different capital charge depending on whether the model of the desk where it is traded is granted approval or not. The internal model authorization at a trading desk level could lead to imbalances and potential regulatory arbitrage. Although we advocate the possibility of gradual implementation, such an implementation should avoid the above mentioned consequences.

***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?***

- From a methodological viewpoint, the direct method seems more accurate however the use of proxies would miss information and quality. The drawback is that it would add complexity to the process.
- The higher complexity of the direct approach becomes more challenging if it is combined with a desk-level approach for model approval purposes.
- The right balance could be struck by implementing a direct approach with a reduced number of desk-level groups.
- An alternative hybrid approach could be as follows:

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<sup>2</sup> Internal Models Approach to Market Risk

- Calibrating the Expected Shortfall to current conditions and scaling it up to a stress level in a dynamic fashion (this is more or less done in the indirect method except that the introduction of Maximum Stress Loss concept somehow pollutes the intention).
- Practically speaking, we propose to replace the indirect approach by the following formula, which we believe better captures the intent:

$$ES_S = ES_{FC} \frac{ES_{RS}}{ES_{RC}}$$

- This approach provides an Expected Shortfall measure based on current Expected Shortfall ( $ES_S$ ) and scaled by the ratio of Expected Shortfall based on a set of reduced risk factors scenarios observed in a period of stress ( $ES_{RS}$ ) to the Expected Shortfall based on the same reduced set of risk factors observed in the current period ( $ES_{RC}$ ). In other terms, the outcome is an Expected Shortfall based on current period (and hence useful for day-to-day risk management and for backtesting) scaled to a stress level to achieve the capital requirements calculations. The scalar can be computed on a daily basis so as the adjustment to the stress level remains by all times effective.

**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?***

- In the EBF view, the approach proposed by the Committee, under which banks should use supervisor-prescribed parameters for the correlation between risk classes, would put at risk the consistency of the entire model.
- It is hard to believe that regulatory factors would be meaningful for business purposes, therefore the use test would not be met and the approach would represent only a regulatory compliance obligation.
- As with liquidity horizons we would not advocate methods which are difficult to implement in a framework of historical simulation. Correlations of VaR figures themselves would be rather meaningless. We would therefore seek for alternative methods to limit diversification benefits.
- The solution is to allow banks to apply correlation between risk classes determined within their internal models. The EBF defends the use of internal model correlations as they depend on the portfolio composition which cannot be factored in by a standardised model.
- In case that the Committee considers the implementation of the proposed regulatory correlations, it is important to resolve the problem of the separation between exposures under internal model and under standardised model. The proposal envisages the calculation of the correlation on a separate basis, i.e. the requirements of IMA and standardised would be additive. The EBF thinks that correlation should be calculated across portfolios independently of the method used.

- It is acknowledged however that BCBS should monitor the outcomes across banks instead of setting prescriptive parameters.
- 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)?***
- We believe most of the credit risk in the trading book is not “rating-related” but rather “spread-related”. In other terms, large movements in credit spreads are a much more relevant to trading book than rating migration (which very often lags behind spreads anyway).
  - The IRC in combination with other charges tends to exaggerate the risks. Depending on the settings of the new market risk model, it might be concluded that IRC will not required anymore, as the level of capital for positions with credit risk is sufficient (and in line with the banking book) in the new framework. It should definitely be avoided to replace the current model with another one with the same complexity in developing and implementation.
  - In our opinion, modeling of credit risk and market risk should ideally be integrated. The double-counting of spread risk in stressed markets with migration risk should be avoided hence we think the concept of migration risk within IRC should be at least reviewed. However, a perfect solution to integrate these risks is not available and will be costly. In fact, banks applying the Basel framework into force (so called Basel 2.5) have just implemented consistent models for credit risk (IRC models). Since the continuous change of rules concerning the risk measurement models entails significant costs for banks, it should be avoided where possible.
- 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?***
- A number of banks do not foresee significant constraints moving to ES. Others point out sample size and mixed liquidity horizons as main constraints. The proposal to introduce the expected shortfall and longer liquidity horizons results in an increased 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 outliers. It should also be noted that banks with smaller portfolios will have limited observations.
  - It has to be considered that the VaR metric worked properly for the main portfolios, as tail risk is not a major issue for books with relatively plain vanilla products. Many banks do not have issues with VaR calculations, i.e. a limited number of outliers were reported, even during the crisis. As a result, for most portfolios with limited *optionality*, the ES is a fixed multiple of the VaR, and the added value of ES is quite limited.
  - It is not clear how the ES can be easily back-tested and how to determine the consequences from the back test. This remains a challenge for the use of this metric.

- All in all, whilst we acknowledge that the current Value at Risk metric does not appropriately capture tail risks, which are central to the calculation of the capital buffers that should enable banks to absorb severe and irregular market shocks, we are not comfortable with replacing it systematically with an expected shortfall metric.
- Instead we recommend keeping the possibility for banks with small to intermediate trading books mainly composed by plain vanilla products to continue to use a VaR metric for internal models. For those banks the deficiencies of the VaR metric as to capturing tail risks could be addressed by applying add-ons or floors calibrated in order to ensure an appropriate level of regulatory capital. A possibility would be to look at the outcomes beyond the 99%. This would give an indication to which extent there could be significant tail risk warranting further investigation.
- The current proposal explicitly forces banks to full revaluation. This makes sense for non-linear portfolios. For linear books (e.g. plain vanilla interest rate swaps) however the EBF is of the opinion that sensitivity based approaches can be maintained by allowing banks to prove that the benefit of using full revaluation (for certain product categories) is immaterial.
- For banks with complex trading books and large infrastructures, we support the Committee's proposal to move to an Expected Shortfall type of measure. We believe however that such measure would only be appropriate and manageable if the confidence level is lowered (the 95<sup>th</sup> percentile would be a good candidate for instance) as a too high percentile will lead to a very unstable measure, hard to backtest and hard to model as well (a too high threshold would not allow for enough observations from which to form the average losses). In addition, banks should be free in their choice of simulation approach, i.e. banks should not be forced to convert from a historical simulation to a Monte Carlo simulation. The operational efficiency of historical simulation can be maintained by setting the boundary to the 95% level instead of the 99% level. In that way, a sufficient number of tail observations can be used to estimate a reliable ES figure.

**9. *Which of the two approaches better meets the Committee's objectives for a revised standardised approach? Do commenters propose any amendments to these approaches?***

- The challenge of the standardised approach is to cater demands of a different nature:
  - Firstly, it needs to be a credible fallback for banks which may not receive model approval for individual desks or which eventually see certain internal models temporarily switched off for regulatory purposes.
  - Secondly, the standardised approach is to be designed in such a way that it does not overstrain the capabilities of smaller banks.
- The latter seems to be the most restrictive factor to consider as it would be unaffordable for a number of non-IMA banks to establish the infrastructure that is otherwise only necessary for model approval and to maintain it on a sustained basis at great effort and expense (e.g. with regard to pricing tools, supply of market data, loss distribution estimates, investments in software, etc.).

- In particular, European non-IMA banks would have to face two overlapping costs to run their simple trading activities (mainly cash-like instruments):
  - An important investment to be made in information systems.
  - Additional core equity capital (CET1) would need to be raised for the same amount of the investment in information systems, unless software were not deducted from CET1 in the EU as it is the case in other jurisdictions.
- We disagree with the introduction of regulatory capital floors based on standardised approaches, as it is a disincentive for the use and further development of internal models and makes it more difficult to calibrate the standardised approach.
- A requirement for banks to calculate two standardised approach methods for comparison reasons would be overburdening and could be misleading. For these reasons the EBF defends that banks should be allowed to opt for either of the two approaches depending on their needs and capacities. This ought to be possible if both approaches are calibrated appropriately.

***10. Do commenters propose any amendments to these approaches?***

- Regarding the treatment of credit, although the VaR and/or ES measures do not explicitly cover migration and default risk, it should be carefully considered to avoid duplication of risk. We recommended that further impact analysis is done to: (i) Compare the outcomes with the current IRC outcomes and (ii) compare the outcomes with the banking book results for similar positions.
- The Committee asks whether the credit valuation adjustment (CVA) charge should be integrated in the market risk framework. We believe that the CVA issue goes beyond the mere fact of the integration on the market risk framework as such integration is only relevant for banks having certain approaches to CVA risks and does not necessarily address other outstanding issues.

The proposed treatment of CVA in Basel 3 raises indeed numerous problems:

- The CVA requirements are like dynamic provisioning: they already anticipate the potential risk of default of a counterparty. Adding a capital charge to cover their potential increase and basing this charge on market parameters is massively pro-cyclical.
- Requiring such a capital charge is neither obvious as it consists of protecting banks from the effects of the volatility implied by accounting standards. At default, the LGD is totally absorbed by the CVA itself; therefore capital is of no use.
- The disconnection between the capital charge and banks business model/CVA accounting practices is also very problematic and can potentially create risks where they do not exist.
- Indeed, banks that do not mark CVA to market are required to calculate a capital charge that is based on market credit spread volatility; this volatility however simply does not exist in their

measurement of P&L and earnings. Those banks are therefore induced by a regulatory provision to hedge the “regulatory CVA” in order to reduce their capital charges and its volatility; this not only would be a deviation from their business models but would also cause increased P&L and earnings volatility as it is not matched by any corresponding CVA volatility.

- The incentive to hedge will increase the demand for CDS, in particular for Sovereign CDS, which may have a feedback loop on the price of the debt issuances, in particular in stressed situations.
- This will further exacerbate the pro-cyclicality highlighted above.
- The disconnection is also problematic for Banks that mark CVA to market because they are subject to a capital charge that is not derived from their CVA pricing and risk models; they are required to use methodologies and assumptions that diverge from their internal pricing and risk calculations.
- Moreover, for those banks, the CVA charge is standalone and only account for the credit spread risk. This implies that, on one hand, the CVA risks do not diversify with the rest of the Trading Book risks, and on the other hand, market risk hedges are kept separately in the trading book without offsetting CVA exposures.

We believe it is therefore extremely important that the Committee reconsiders its proposals on the CVA charge, taking into account the differences in business models and the potential unintended consequences of such a pro-cyclical charge and the great emphasis put on the CDS market.

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