ERSTE GROUP

Position Paper
Erste Group Bank AG

Fundamental Review of the Trading Book

Vienna, 06. September 2012

Erste Group was founded in 1819 as the first Austrian savings bank ("Erste oesterreichische Spar-Casse"). In 1997, Erste Group went public with a strategy to expand its retail business into Central and Eastern Europe. Erste Group's customer base has grown through numerous acquisitions and organic growth from 600,000 to 16.6 million, of which 15.5 million clients live in the fastest growing economies of the European Union. These countries benefit from the stable EU regulatory framework. Having always focussed on retail and SME business, today Erste Group is one of the largest financial services providers in Central and Eastern Europe in terms of clients and total assets.

General Remarks

Please note that EGB does not want its comments to be published or disclosed.

1. Introduction

In the following we comment on the main changes proposed by the Basel committee in the consultative document “Fundamental review of the trading book”. 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. In general we are sympathetic to a redesign of the trading book framework as it is currently a patchwork which lacks coherence. On the one hand certain risks are double counted and there is a huge gap between the standardised approach and the internal model approach.

Nevertheless it is expected that the overall operational burden would drastically increase and that the proposal will discourage certain model improvements (like modelling the spread risk).

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.

2. Reassessment of the boundary

Basel committee has identified the ill-defined boundary between trading and banking book as one of the shortcomings which came to light during the financial crisis. As a remedy the Committee proposes two diametrically opposite approaches: **trading evidence based boundary** and **valuation based boundary**.

In the first case, the **trading book** seems to be affected by **minor changes**, compared to the status quo and compared to the second approach. To get a more detailed impression of out coming effects and becoming able to make a more detailed comment on this approach we would need to know how certain positions, e.g. government bond positions, have to be treated in depth.

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.

Erste shares most of the reservations mentioned by the Basel Committee in the paper 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 last, as mentioned by the BCBS in its paper, 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.

In general we assess the trading evidence based approach to be more consistent with current frameworks, less invasive and more appropriate to cover the identified current problems. Based on the current proposal Erste would prefer this approach.

3. Moving to expected shortfall

Instead of value at risk as a risk measure, the committee proposes a new risk measure called expected shortfall which is more suitable to capture tail risk. 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 the 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.

4. Calibration to stressed conditions

As capital charges derived from internal models should cover losses in stressed market periods the committee believes that models should be calibrated to stress periods.

As Erste understands the proposal it is planned to drop the value at risk calibrated to non-stress periods and instead calibrate only to stress periods. In general this can be seen positive as double counting will be eliminated and the calibration and calculation will be more transparent.

5. Factoring in market liquidity

During the financial crisis it became obvious that certain positions which were deemed to be liquid became illiquid and either could not be sold or hedged. 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 a system. It is also expected that these changed liquidity horizons will have an impact on capital requirements. For any deeper analysis on out coming effects we would appreciate to work with a more detailed proposal.

But we also want to address, 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.

This point also needs a critical examination for potential linkages of incorporating the risk of market illiquidity and other aspects of the proposal, e.g. valuation based boundary approach. Especially when switching to new approaches is intended we want to highlight the need for further consideration regarding any cross effects.

6. Relationship between standardised and internal models-based approaches

The committee intends to establish a stronger relationship in the initial calibration of both approaches and a mandatory standardised measurement of all positions in the trading book. It also intends to introduce a floor for the capital requirement from the internal model, which should be a certain percentage of the capital requirement from the standardised approach. The possible floor (footnoted 80% of the standardised approach) could mean that future improvement of the internal models could be impeded.

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

Nevertheless, the calculation of all products in the standardised approach means a necessarily higher attention to the standardised approach and on the other hand a much higher operational burden.

We also see the intentions behind the introduction of a floor for those trading books/desks who want to use the revised internal approach. As the usage of a fixed floor could dis-incentivise internal model approaches we recommend making use of the proposed surcharge. Whenever using the revised internal models-based approach and when a predefined floor becomes trespassed a surcharge could be used for a further linkage of standardized and models-based approaches. By going this wayinternal models wouldstill be able to gain substantial improvements.

7. 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 modellable 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 changedcapital 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.

In addition we want to support the need for a definition of desks by the bank. The bank should keep the discretion about its organisational structure. Otherwise it would be another adverse and unnecessary effect to an enterprise's self-determination.

8. Revised standardised approach

The committee proposes to fully revise the standardised approach. The approach should become more risk sensitive and the recalibration of the risk weights should be done in a transparent way.

All in all 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 for further in-depth analysis.

9. Further Issues

An aspect, the paper does not pick up is the treatment of (quasi) market maker positions. Banks fulfilling this important task will need an incentive as they would be penalised by certain combinations of the proposed measurements otherwise. One situation, but not the only one in this context, we see very critical would be a combination of value based boundary approach and the incorporation of market illiquidity risk. A market maker, forced to take over a high percentage of a certain asset and unable to resell due to a market's illiquidity would be penalised for providing an important market function. Here we would ask for further in depth considerations on what critical functions may be affected and how a potential outcome can look like.