ABI response to the BCBS Consultative Document "Fundamental review of the trading book"

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POSITION PAPER

General remarks

The Italian Banking Association (ABI) welcomes the opportunity to comment on the BCBS Consultative Document "Fundamental review of the trading book"[1].

ABI appreciates the thorough analysis of the Basel Committee and the effort aimed at designing a consistent, comprehensive framework for the prudential treatment of market risks. Moreover, ABI appreciates the Committee's decision to propose different regulatory options, in order to gather inputs from the industry. ABI believes that a consultation in the early stage of any reform is a valuable tool, together with its impact assessment exercise, based on a Quantitative Impact Study (QIS). ABI hopes that the impact assessment methodology for the fundamental review of the trading book will be introduced to stakeholders as soon as possible. ABI also hopes that the forthcoming impact study will be aimed at assessing not only how the proposed regime affects the level of the capital requirements, but also its impact in terms of the implementation burdens.

Moreover, ABI hopes that market participants will be soon made aware of the expected timetable of the reform. In particular, ABI wishes to underline the importance of allowing sufficient time between the definition of the new rules and their entry into force. In order to achieve reliable estimates of the impact of the proposed rules, it is also necessary that institutions are granted adequate time for performing the Quantitative Impact Study.

The trading book review and the accounting reform timetables should be also closely coordinated, in order to ensure that banks can implement the necessary changes in a straightforward manner. They should not be requested to implement any accounting change and amend it immediately afterwards due to the trading book concurrent reform.

Furthermore, ABI appreciates the Committee's attention to the level playing field issue. It is of the utmost importance ensuring the new rules could allow equal treatment among banks in different jurisdictions. To this end, in drawing up the new rules the Committee must be sure that they are ready to be applied in a consistent manner across jurisdictions - it is essential that all jurisdictions apply the reform at the same time.

The following section provides answers to the questions set in the Document. At the end, there are some comments concerning issues not addressed in the questionnaire.

[1] Henceforth, "the Document".

Answers to the BCBS questions

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

With respect to the definition of a new regulatory boundary, the "trading evidence-based" approach appears preferable, while the "valuation-based" approach gives rise to major concerns.

In ABI's opinion, the fact that the standard setters are reviewing the accounting framework is likely to give rise to issues that the Committee seems to underplay, and vice-versa. Indeed, until the perimeter of the financial instruments which will be fair valued is unclear, it is not possible to check all the potential inconsistencies that the "valuation-based" trading book boundary could entail[2]. Moreover, the adoption of the "valuation-based" boundary would give rise to serious level playing field concerns, due to the differences in accounting practices among different jurisdictions (e.g. IAS/IFRS jurisdictions vis-à-vis GAAP).

Nevertheless, a strict coordination between the prudential framework and the accounting rules is desirable. To this end, the forthcoming reforms should be drafted so as to closer align both the prudential and accounting frameworks to the banks' risk management practices.

On the other hand, ABI believes that the "trading evidence-based" boundary is more appropriate, as it allows to keep aligned the prudential treatment and the bank's risk management practices, mainly with reference to the same financial instrument. ABI suggests that the "trading evidence" principle should be related to the genuine trading intent and to the business strategies as defined for each trading desk, regardless of the type of financial instrument. Measures are also required for ensuring a homogeneous application of the boundary among jurisdictions.

Last but not least, the Document always refers to "instruments" to be included (or not) in the trading book. This could be interpreted as if the whole amount held by the bank of a certain instrument (e.g. all bonds with the same ISIN) were to be classified in the trading book (or not). However, banks often hold amounts of the same instrument for different purposes. Hence, they should be allowed to classify an instrument partly in the trading book and partly in the banking book. The Committee should clarify that, within the context of the trading book boundary, the word "instrument" has

[2] An example of inconsistent outcome of the valuation-based approach could be whether fair valued options embedded in loans set in the banking book were to be considered as part of the trading book.

to be intended as “a certain amount of an instrument” and not as “the whole amount held of an instrument”.

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?*

With regard to treatment of market illiquidity risk, in ABI’s opinion “Option 3” (Annex 4 Paragraph 2) is the best solution for incorporating the portfolio liquidity in the market risk metric, as it is the simplest one and the methodological challenge it poses (choice of an appropriate measure of exposures) does not seem insurmountable.

Instead of applying the proposed approach at a portfolio level (applying a unique weighted-average liquidity horizon, determined for the whole portfolio, to all trading desks), it could be applied at a trading desk level (determining a weighted-average liquidity horizon for each trading desk). In ABI’s opinion such second option is preferable, since it appears more precise and provides more meaningful model outputs with a view to the so called “use test”, even if a methodology for the aggregation of the desk-level results would be built-up.

With reference to the capital add-on for jumps in liquidity premia, ABI basically agrees with the proposed approach. However, ABI deems it appropriate that any specific provisions set aside by a bank to cover the risk of illiquidity arising from its own assets should be taken into account. ABI suggests that the bank’s exposure for the purpose of the calculation of the add-on should be offset with these provisions. This would address a double counting issue and avert the risk that the forthcoming regime discourages such provisioning.

An in-depth analysis should be dedicated to the relationship between collateralization and liquidity, with a view to taking into account collateral when determining illiquidity provisions.

Finally, it is deemed useful that the Committee explicitly confirms that the proposed approach - including the incorporation of varying liquidity horizons in the market risk metric and the capital add-on for jumps in liquidity premia - should be directly applied by banks using internal models, while no task will be required for banks applying the standardized approach, as the liquidity horizons are taken into account by the regulator when determining the regulatory risk weights.

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

ABI remarks that the mandatory standardized measurement will be burdensome for banks applying internal models. In particular, simultaneously maintaining and monitoring two different computational frameworks (i.e. internal model and standard approach) at a bank-wide level could be critical, in terms of increase in costs and monitoring efforts.

The Committee should focus on promoting appropriate incentives to adopt internal models.

An appropriate definition of the detailed provisions will be very important in order to limit - to a certain extent - the computational burden. For example, banks should be required to perform the calculation of the standardized capital requirement no more than on a quarterly basis.

In this regard, the form of disclosure of the output of the standardized approach is relevant as well. In ABI's opinion, it should be regularly disclosed to the supervisor alone; disclosure to the market should only occur in the event that the final capital requirement of the bank is affected by the calculation under the standardized method (e.g., in case of introduction of a floor, if the capital requirement calculated through the internal model falls below the floor).

At all events, ABI believes that no further measure - like floor or surcharge based on the outcome of the standardized approach - is appropriate. Should the Committee think otherwise, a floor should be preferable, depending on its level.

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?*

ABI highlights that the desk-level approval process would determine the loss of uniformity, and finally the consistency, of the internal model of the bank. For example, the same financial instruments could imply a different capital charge, depending on whether the trading desk where it is traded sees its model approved or not. Moreover, the internal model authorization at a trading desk level could lead to regulatory arbitrages and moral hazards that arise from the capital absorptions obtained through the

internal model or the standardized approach. In addition, it could give rise to problems with reference to some operations, e.g. internal deals.

If the trading desk based approval process is confirmed, it is important that the regulator ensures a flexible and direct switching mechanism of trading desks between the standard approach and the internal model (and vice-versa) accordingly to the P&L attribution and backtesting performances, without requiring any further validation process.

As to the treatment of FX and commodity risk positions in the banking book, the solution ensuring a more consistent integration of these positions in the internal model seems to be the third option illustrated in Box 1, Paragraph 4.2.2 (i.e. defining two notional trading desks for FX and commodity risk positions).

Finally, it should be noted that the management of the proposed approach is likely to result in significant complexity for supervisors as well.

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?*

In ABI's opinion the "direct method" seems preferable, despite being more complex.

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?*

Regardless of the chosen aggregation mechanism, ABI does not agree with the approach proposed by the Committee, under which banks should use supervisor-prescribed parameters for the correlation between risk classes. In ABI's opinion, it would be preferable that banks were allowed to apply correlation between risk classes determined within their internal models.

The use of supervisor-prescribed parameters would imply a lack of consistency of their entire model, once more undermining the significance of the output of the internal model for risk management purposes (so-called "use test"), and does not seem necessary since other mechanisms are available for ensuring that banks do not overestimate diversification benefits (e.g. supervisory approval of the model; evidence of the suitability of the correlation parameters and of their robustness in periods of financial stress; benchmark to the risk measure calculated under the standardized approach – and perhaps a floor). In order to avert the risk that banks overestimate diversification benefits, a further measure could be defined,

i.e. allowing the use of internal correlation parameters provided that they are not too different from those determined by the regulator. Convenient indicators should be chosen for assessing the “difference” and setting the thresholds (the extent to which this difference is considered acceptable).

It should also be noted that no consideration of diversification benefits is allowed between desks applying internal models and desks under the standardized approach. The lack of consideration of diversification benefits in this case does not seem justified. In ABI’s opinion, the aggregation of the output of the internal models (for eligible trading desks) and the requirements calculated under the standardized approach (for ineligible desks) should not follow a “building block” approach, but should be made according to the formula (1) (Paragraph 4.5.6, pg. 40 of the Document), by applying appropriate correlation parameters.

Finally, with respect to the correlation parameters, clarifications are needed on whether it would be possible to use proxies and, if so, under which rules.

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)?*

In ABI’s opinion, credit risk modelling should be kept separate from market risk modelling. In fact, banks applying the Basel framework in force[3] (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 determines a significant impact on banks, it should be avoided where possible, unless it ensures remarkable benefits.

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?*

No major operational constraints have been identified with reference to the Expected Shortfall metric, even though further analyses are to be conducted on the backtesting methodology.

[3] Basel Committee on Banking Supervision, *Revisions to the Basel II market risk framework, updated as of 31 December 2010*, February 2011 and *Guidelines for computing capital for incremental risk in the trading book*, July 2009.

From a practical perspective, ABI suggests that the confidence level for the Expected Shortfall be set at 95%. This confidence level would ensure that the estimates of the “tails” are based on an adequate number of values, thus making them reliable and less volatile.

9. *Which of the two approaches better meets the Committee’s objectives for a revised standardised approach?*

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

ABI wishes to emphasize that both the proposed approaches appear computationally burdensome, in particular the “fuller risk factor approach”. As acknowledged in the Document, the latter could be particularly troublesome for smaller banks, due to the reliance on banks’ pricing models.

Whatever the chosen approach, it should be considered that if the Committee defines a boundary that enlarges the scope of the trading book, the burden would further increase compared to the present (because of the larger trading book in addition to a more complex methodology).

In ABI’s opinion, the “partial risk factor approach” is sufficiently risk-sensitive to meet the objectives set by the Committee. Therefore, in being clearly simpler and not relying on banks’ pricing models, it appears to better fit with the principles set by the Committee for the design of the revised standardized approach.

The more complex and risk-sensitive approach - the “fuller risk factor” approach - is not needed.

With respect to the calibration of parameters, a question arises concerning the frequency of the update. In ABI’s opinion, a frequent update is not needed, in the light of the fact that the parameters are the result of a stressed calibration, thus they should not be significantly affected by changes in the market conditions, except in stressed periods. Therefore, an update of the parameters would be needed only following periods of stress.

Should a regular update be preferred, in ABI’s opinion the time span should be no less than three years, which is the usual duration of a bank’s business plan. The idea is that bank business plans should be based on reliable estimates of the capital requirements.

Other remarks

The Committee asks whether, in the commenters' view, the CVA charge should be integrated in the market risk framework.

In this respect, ABI believes that the ideal solution would have been to have CVA rules consistent with the market risk framework. However, the entry into force of the new CVA charge - in the form defined in the Basel 3 regulations[4] - is very near, and the implementation of the related procedures on the part of the banks is at an advanced stage. Therefore, ABI believes that changing the CVA capital requirements framework now is untimely. Since the banks have already sustained costs, it is preferable to maintain the Basel 3 approach, at least until the trading book reform is in force, and assess it before planning any change.

Finally, clarification is needed concerning the scope of the revised framework. In particular, it is deemed necessary that the Basel Committee clarify that the proposed framework only applies to internationally active banks, like the rest of the Basel regulations.

[4] Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems (revised June 2011)*, June 2011.