Annex - 1

Comments of Saudi Arabian Banks on
Basel Committee on Banking Supervision (BCBS) Consultative Document Entitled
"Fundamental Review of Trading Book"

BANK # 1

Reassessment of the boundary between the trading book and the banking book

Under the present regime a key determinant of the regulatory boundary between banking book and trading book exposures is the bank's intention to trade. The Basel Committee criticizes the "intent to trade" test as being difficult to police, insufficiently restrictive and subject to regulatory arbitrage. It proposes two alternatives: a "trading evidence"-based boundary where instruments will be admitted to the trading book provided that the bank has trading intent plus proven ability to execute that intent and a "valuation"-based boundary where the trading book will be defined by those items which are fair-value accounted.

Bank Response

One of the major issues of the financial crisis was the ability of banks to arbitrage between the two books; We therefore believe that the tightening up of rules about where assets are accounted for can only help. We however believe that allowing for 2 options could create inconsistency in the definition of 'trading book'. The first option could result in narrower trading books while the second would more likely result in expanded trading books.

Comments above are valid under the assumption that both options are available and banks will have options to choose one. However, if the question here is which of the two options is more suitable, from the Regulatory perspective, to address the issue, then *"option where the trading book will be defined by those items which are fair-value accounted"* is closer to how banks monitor and manage their books/exposures since MTM of AFS exposures also impact availability of capital.

Calibration to stressed conditions

The Basel Committee notes that a key feature of the trading book regime prior to the financial crisis was its reliance on risk metrics calibrated to current market conditions. It goes on to explain that this resulted both in under capitalised trading book exposures going into the crisis and market risk capital charges that proved procyclical at the height of the crisis. The Basel Committee intends to develop a capital framework for the trading book that is calibrated to a period of significant financial stress (as opposed to current market stress), thereby enhancing absorption of loss during critical periods and reducing the cyclicality of market risk capital charges.

Bank Response

We believe such a uniform capital rule could encourage herding where banks will end up having a trading book that would be very robust if the last crisis happened again, but which is vulnerable to the next one. Banks would for example calibrate their trading books to the last financial crisis while in reality the next crisis could have a totally different dimension to it.

With reference to above, though the severity of the next crisis will always be unknown, yet calibration of stressed conditions to last significant financial stress (as opposed to current market stress) would result in higher comfort levels i.e. enhancing the capacity for absorptions for losses.

Moving from value-at-risk to expected shortfall

The metric used to capitalise trading book exposures is a value-at-risk (VaR) measure aimed at capturing the risk of short-term fluctuations in market prices. The Basel Committee notes that use of the VaR method stems largely from historical precedent and industry practice, and that weaknesses in the method have been identified such as its failure to capture tail-risk (ie. where the risk of extreme price movements is in fact greater than assumed in the normal distribution). The Basel Committee sees the "expected shortfall" (ES) method for determining regulatory capital requirements as more desirable than the VaR method. Despite recognising operational challenges that would come with the proposed move, the Basel Committee believes that those challenges would be outweighed by the benefits of adopting a method that is more sensitive to assessing tail-risk. The main stated benefit is that whereas VaR provides a lower bound on extreme losses ("you'll lose at least this much, but we can't say how much worse it could get"), ES tries to quantify what dangers lurk in the tail of the loss distribution ("this is the average of the really bad losses").

Bank Response

We appreciate the fact that while this aspect of the review has received a lot of attention, it is not a massive change. Banks will still be able to use their existing VAR infrastructure to calculate ES, and ES charges – while larger than VAR – should behave much like a stressed VAR.

We however note that since ES relies on much the same simulation framework as VaR, it still suffers from some of the other drawbacks, such as the assumption that looking into the past can tell you something about the future. Also, back-testing ES (i.e. trying to judge whether your model is in fact good at predicting the future) is a lot more complex than back-testing the simpler VaR concept and this could pose modeling challenges to banks.

The proposal clearly admits that putting confidence levels in risk parameter estimates (like VaR) is no more relevant for banks' capital adequacy assessment; this could be acceptable for capital assessment under stressed conditions. However, it

seems given the increasing frequency of stress events, the whole Regulatory perspective is changing and banks would be required to maintain capital accordingly i.e. admission that risk of extreme price movements is in fact greater than assumed in the normal distribution.

Factoring in market illiquidity

The Basel Committee notes that the existing regime for capitalising trading book exposures does not adequately take account of the risk of severe impairment of market liquidity seen in the recent financial crisis. The Basel Committee's proposed approach to factor in market liquidity risk consists of three elements. The first one involves the introduction of a concept of "liquidity horizons" to represent the time required to sell a financial instrument, or hedge all its material risks, in a stressed market without materially affecting market prices. Exposures would be placed into one of five "liquidity horizon" categories ranging from 10 days to one year. The second element involves incorporating the varying liquidity horizons in the regulatory market risk metric to capitalise the risk that banks might be unable to exit or hedge risk positions over a short time period. The third element involves enhanced capital requirements associated with jumps in liquidity premiums, subject to meeting specified criteria.

Bank Response

We believe that this proposal, of introducing liquidity assessments into market risk measures, is prescient in the light of recent multi-billion dollar trading losses in illiquid credit default indices. However it seems unlikely that the traders taking on those positions didn't know that there was finite liquidity available, and so the question is whether or not a liquidity indicator would have led to management/risk management overruling the trading desk's strategy. We believe that clearly highly liquid areas (FX, most cash equities, some rates) will benefit from these proposed changes, while less liquid ones (most junk credit, most ABS) will suffer.

Given the proposed changes in points 2 & 3 above, this proposition seems excessive. Is not that by (proposed) shifting to significant financial stress as opposed to current market stress (point 2 above), and by (proposed) inclusion "tail risk" assessment (point 3 above) the banks would already be accounting for *"the risk of severe impairment of market liquidity*"? Impairment of market liquidity is largely an "effect" and not the primary cause.

Alignment of the internal models-based and standardised approaches to hedging and diversification

An important element of the Basel Committee's proposals is to more closely align the treatment of hedging and diversification between the internal models-based and standardised approaches to capitalising trading book exposures. Its guiding principle is that the capital framework should only recognise hedges if they are likely to prove effective – and can be maintained – during periods of market stress. To this end, the

Basel Committee proposes to limit the large latitude currently afforded to users of the internal models-based approach to recognise the risk-reducing benefits of hedging and diversification. At the same time, the Basel Committee aims to increase the risk sensitivity of the standardised approach, in part by factoring in increased recognition of hedging. The Committee is proposing to more closely align the treatment of hedging and diversification between the standard rules and internal models.

So this cuts two ways: reducing the diversification (and perhaps hedging) benefits for banks with models permissions, while increasing them for standard rules banks.

Specifically the Committee proposes

- Constraining diversification benefits in the internal models-based approach to address the Committee's concerns that such models may significantly overestimate portfolio diversification benefits that do not materialise in times of stress.
- Supervisor imposed (stressed) correlations will be a floor to diversification benefit within the internal models regime; and
- Revisions to the standardised approach that will enhance its risk sensitivity.

Bank Response

There is very little detail from the Committee on this aspect and we do not have a specific comment re this point.

Revision of internal models-based and standardised approaches

The Committee considers the current regulatory capital framework for the trading book to have become too reliant on banks' internal models that reflect a private view of risk. In addition, the potential for very large differences between standardised and internal models-based capital requirements for a given portfolio is a major level playing field concern and can also leave supervisors without a credible option of removing model permission when model performance is poor. To strengthen the relationship between the models-based and standardised approaches the Committee is consulting on three proposals:

- First, establishing a closer link between the calibration of the two approaches;
- Second, requiring mandatory calculation of the standardised approach by all banks;
  and
- Third, considering the merits of introducing the standardised approach as a floor or surcharge to the models-based approach.

The Basel Committee is proposing changes to the internal models-based and standardised approaches, including a closer link between their calibration. For the internal models-based approach, other proposed changes include measures to

reduce model risk, such as a more granular models approval process at the trading desk level and constraining diversification benefits.

A revised standardised approach would be intended to be more risk-sensitive and act as a credible fallback to internal models, and on this point the Basel Committee seeks feedback on what it calls a "partial risk factor approach" and a "fuller risk factor approach".

Bank Response

We believe the calculation of capital charges using both the internal model and the standardised approaches would provide a conservative way forward.

The appropriate treatment of credit

The Basel Committee notes that a particular area of focus for its review has been the treatment of positions subject to credit risk in the trading book. Currently, default risk and migration risk are modeled separately for the purposes of capital charges (the market risk framework capitalises jump-to-default (and ratings migration) risk via IRC models, while charging for credit spread risk in VAR) . One motivation behind the review was to simplify the patchwork of capital charges applied to the trading book, but the consultative document explains that combining default and migration risk within an integrated market risk framework introduces unique modelling challenges. For that reason, the Basel Committee is considering whether default and migration risk should continue to be modeled separately in the trading book or whether there should be a single model for this.

Bank Response

We believe this is a good initiative as long as there will also be consistency between the treatment of the same risk in the banking and trading books.

BANK # 2

- The Fundamental Review recognizes a number of shortfalls in the approach used by Banks to evaluate capital requirements for Market risks and proposes a number of options to improve the regulatory framework, as well as improving the linkage between the standardized approach and the model based approaches.

Overall, bank welcomes the changes being proposed and believes that these revisions will lead to a more comprehensive level of capital coverage for trading and banking book positions.

The observations from this bank are as follows:

Section 3.1 Reassessment of the Boundary

The review seeks to identify a replacement definition to differentiate between trading and banking book portfolios for risk assessment purposes.

Bank recognises the need for improvements in this area and on balance would see the trading evidence based boundary (Option A) as a suitable replacement.

The alternative Valuation Based boundary raises concerns regarding a potential disincentive to hedge interest rate risk for existing positions held at fair value. The approach also appears too dependent on account based rules rather than banking capital standards leading to a potential misalignment of market risk capital requirements.

Section 3.2 Risk Metric for Calibration to Stressed Conditions

The Expected Shortfall (ES) approach appears to be the more comprehensive approach than the existing VaR model for regulatory capital purposes.

The main area of concern is how the multiplication factor or Scalar will be derived for each risk factor as the Saudi market is still developing and the trading histories and depth of capital markets has not fully matured making quantitative derivation difficult. Similarly, the use of proxy values from other markets may over estimate the risk and lead to a disincentive and slow the development of the market. As the proposed values are not known, we wish to stress to the committee the importance of establishing Scalar values that reflect local market asset classes such as Government, Quasi Government, and corporate assets.

When calibrating the ES approach it will be important for the committee to consider the possibility of double counting or over estimation effects, and thus magnifying the capital requirement beyond what is prudent.

Banks have been using VaR models for a prolonged period of time and market risk systems have been designed with these types of methodologies embedded within the architecture. Therefore any migration away from a VaR based model will require a significant amount of operational work to reconfigure systems and embed the new methodology within internal processes, the complexity of which should not be under estimated.

Section 3.3 Factoring in Market Liquidity

When considering the risk factors to be applied to capture the market liquidity capacity, which are required to offset or eliminate a position over a short period at current prices, careful consideration needs to be given to the maturity of the market and calibrated so as not be act as a barrier to the development or investment in local market instruments.

The Saudi market is still developing with the number of traded instruments are limited which will lead to a lack of adequate float and trading activity as investors will retain instruments until maturity. This could lead to a false impression of illiquidity, however this is not the sort of liquidity problem that would cause prices drops.

Section 3.5 Relationship between Standardized and Internal Models Based Approaches

The current regime contains material differences between model outcomes and standardized capital charges, which are exemplified by the foreign exchange risk capital charge for pegged currencies, such as SAR vs USD which attracts an 8% capital charge under standardized compared to around 1% using a VaR model approach.

Bank welcomes the recommendation to improve the alignment of the two approaches, with the proposed Floor based approach providing a level playing field for all banks. However the Benchmark approach provides the most flexibility allowing local regulators to align requirements to local market conditions, something that it considered an important consideration for emerging markets where the development and expansion of capital markets is also an important consideration. This approach would also enable flexibility when assessing Islamic Banking instruments.

Section 5 Revised Standardized Approach

Both the partial risk factor approach and the fuller risk factor approach provide an improved framework for generating the standardized capital requirement. Bank is supportive of the proposal from the Committee for the partial risk factor approach.

There are no further comments relating to the Fundamental Review of the Trading Book, although Bank would welcome the opportunity to review further the proposals for interest risk measurement once these are issued by the Basel Committee on Banking Supervision.

BANK # 3

1. Bank's trading activities are quite limited in nature; however, from a conceptual perspective and given the continuing crises in the financial industry it is prudent to revise and update the definition of the trading/banking books. BCBS should, however, aim for a balance approach so that the primary objectives behind this review are achieved in a reasonably efficient and optimal way for banks of all sizes and nature of activities across the globe. In that vein, a trading evidence based boundary would be a better approach.

2. Within the market risk capital framework and to strengthen the relationship between the models-based and standardized approaches, the partial-risk factor proposal would be a practically reasonable 'upgrade' of the standardized approach. Furthermore, introducing the standardized approach as a floor or surcharge to the models-based approach appears to be a prudent safeguard from a systemic and regulatory perspective.

3. Finally, factoring in market liquidity is important but the methodology options proposed will pose implementation challenges and constraints. Given the recent lessons learnt in the financial industry, the challenges and costs are worth it. However, a practical way forward in the case of catering to this may be to devise a criteria that would make it mandatory for 'at risk' banks as opposed to blanketing all with a complicated requirement.

BANK # 4

The Bank has the following issues and comments with regard to the Fundamental Review of the Trading Book.

1. Details required to implement transit from Value at Risk (VAR) estimates to Expected Shortfall given the absence of any local guidelines in this respect.

2. Any impact on risk weight under standardized approach using the proposed Expected Shortfall Approach. (ES).

3. Islamic Trading Instruments (such as Sukuk) due to their very nature and depth of Islamic financial markets require higher level of liquidity coverage, how does BCBS plan to link this with liquidity premia and associate capital add-ons resulting therefrom.

BANK # 5

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

Bank Comments: While both approaches have their advantages and disadvantages, we believe that the "valuation-based" approach will address most of the weaknesses of the current "intent-based" boundary approach. The valuation-based approach about banking book hedging positions to be treated as part of the trading book which might discourage hedging of interest rate risk in the banking book.

Hence, if it is decided to go with the "valuation-based" approach, the Committee should consider including the potential adjustment to the valuation-based boundary as mentioned in the document.

- **What are commenter's 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?**

Bank Comments: There is subjectivity involved in classifying holding into appropriate liquidity horizons. This means that two banks have the same portfolio may use different liquidity horizons; thus resulting in different capital charges. Moreover, portfolio concentration changes will result in different endogenous factors which may in turn be very subjective.

Another area is that current systems readiness may present an operational constraint.

Finally, stressed market factor needs to be defined and should be uniform for all banks.

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

Bank comments: We support the proposed regime as it strengthens the relationship and narrows the gap between the two approaches. We also believe that some consideration should be given to correlation even under the Standardized Approach.

- **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?**

Bank Comments: We are generally in favour of moving to a trading desk approach as it is more consistent in approval model effectiveness at desk-level. However, smaller banks may not have sufficient volume to justify the desk-level approach.

- **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?**

Bank comments: The direct method in our view will provide better reflection of stress periods in the capital charge. With the alternative approach of allowing banks to identify a subset of risk factors to search for relevant historical periods, then applying them to calibrate the ES will give a true estimation of the risk as it will account for the relationship between all risk factors (rather than just scaling up which might not necessarily be accurate).

- **What are commenters' views on the merits of the desk-based and risk-fator-based aggregation mechanisms to deliver the Committee's objectives of constraining diversification benefits?**

Bank Comments: We prefer the risk factor-based way since it allows managing of the overall risk factor across trading desks rather than on a trading desk level. Another point is that some banks may not have sufficient volume to justify different trading desk approach.

- **How can regulators ensure robust supervision of integrated market and credit risk modeling? In particular, how would an integrated modeling approach affect other elements of the proposed framework (e.g. the choice of the quantile parameter for ES, the P&L attribution and backtesting processes, etc)?**

Bank Comments: We prefer using the integrated approach because this will capture the credit risk along with market risk in one risk metric. Although the integrated approach may not be operationally demanding; however, calibrating the ES model to include isolated and rare default events is challenging.

- **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?**

Bank Comments: There are likely to be operational

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

Bank Comments: We prefer the partial risk factor approach since it will result in consistent calculation of capital across banks having the same portfolio.

- **Do commenters propose any amendments to these approaches?**

BANK # 6

- **Trading Book / Banking Book Boundary:**

  Option 1: Trading evidence based boundary:

  - Easy implementation given the test of recognizing changes in fair value through P&L and has less disruption to the current setup of most banks definition of trading books.
  - Issue: Banks can have significant market risk exposure in the banking book which would not attract sufficient capital charge.
    - For Example: Banks equity portfolio on AFS in most banks would only be attracting a 8% capital charge where as in reality the equity portfolio should take into account its potential volatility and liquidity of the positions in the book to ascertain the correct capital charge.

  Option 2: Valuation based boundary:

  - Given it goes by fact that if it is fair valued instead of amortized cost it should attract the market risk capital charge. The capital charge methodology becomes easily aligned to the accounting definition and reduces arbitrage opportunities for banks to hold volatile securities on AFS and only use the credit risk based capital charge against that exposure.
  - However, it introduces significant operational difficulties because the "trading book" definition just got a lot wider and would result in a significant increase in the size of the regulatory trading book.
  - It will also muddle the risk management policies and procedures practiced in most banks which will have to be modified to account for securities on AFS which might not be as liquid and hedge able as the traditional definition of trading book required.

The 2 alternative boundary definitions, Trading evidence based and Valuation based boundary, would result in regulatory trading books which are quite different from a size and composition perspective and consequently, for capital requirements. These definitions could still leave room for arbitrage between the 2 books. Secondly, these definitions could result in inconsistent treatment or classification of trading and banking books as accounting standards and regulatory standards are not aligned. As a result, the accounting trading book and regulatory trading books will be different.

Under the trading evidence based boundary is the requirement to monitor market liquidity levels and specify an expected maximum holding period with potential penalties if that period is exceeded (page 16). For the 1st requirement, in the OTC markets, it will be a challenge to monitor market liquidity or turnover levels. For the 2nd requirement, monitoring of the holding period is difficult as instruments may not be transacted on a matched basis at all times and accounting treatment based on

average cost would complicate matters. Partial sales with intervening purchases would make the monitoring process resource intensive and challenging.

Under the valuation based boundary, the regulatory trading book would be consistent with the accounting trading book. However, the boundary will be driven by accounting rules & standards instead of Basel. It is suggested that Basel committee work together with the accounting bodies to come up with suitable standards that would align the capital requirements on risks posed by instruments that impact the regulatory and accounting solvency of banks.

Where financial instruments that are accounted for on fair value basis but not traded by banks, Basel could consider imposing additional risk capital charges to equalize with that for the banking book. These instruments could be loans or mortgages held for securitization or structured transactions.

Recommendation:

We would recommend that Basel should stipulate that the trading book definitions should be kept as today in most banks based on option 1 which is the "trading intent" definition. The current set of recommendations under this options have strengthened the controls on the trading book.

However, we do recommend that Basel Committee should go the extra step within this option "1" to deal with exposures on AFS accounting where fair value variations and changes only go through the equity line. These exposures if deemed to have market risk should be stipulated to have the additional market risk charge applied in addition to the credit risk charge on account for the true risk of the exposure on the banking book. It does sound a bit like the second recommendation of applying market risk capital charge to all fair value financial instruments but it stops short of changing the "trading book" definition and set disciplines of trading book and its risk management policies and has least amount of disruption for the banks set procedures and policies.

- **Stressed Calibration and ES metric**

As general comment we believe that this lack or shortage of appropriate risk capital allocation to stressed VAR conditions for the market risk factors was a key contributor to the issues faced in the financial crisis of 2008. However, we would like to point out the fact that this stressed VAR or ES expected shortfall calculation approach addresses only the trading book whereas most of the large banks issues arose from securities held in their banking books which under stress resulted in large financial losses which due to the equity line fair value accounting or HTM (held to maturity) accounting were not realized on an ongoing basis in the income line. While we will given our comments to the recommendations but point out that we recommend this stressed approach to be applied not only to trading book but to all instruments which carry market risk and follow fair value accounting treatment such

that appropriate capital is charged irrespective of the fact that the market risk instrument is on trading book or banking book, as long as it is has market risk.

ES shortfall approach while theoretically can capture the highest ES results over the entire "historical period". The concern we have is that this approach gives too much leeway to the banks on choosing the approapriate "historical period". Take for instance for the last 20 years which would probably be considered a long enough historical period we will observe that bond yields have been consistently trending down. Hence, consider an example portfolio of only long dated fixed rate govt bonds in a bank's books. This portfolio would pass most of the stressed VAR or ES approach based on historical data because we have really not seen a very large bond market meltdown. This could result in banks holding very large fixed rate bond holding which in case of a large bond market meltdown globally could result in breaching the ES based appropriate capital calculations.

Varying liquidity horizon definition if standardized by Basel will remove significant amount of arbitrage, hence we recommend standardization of liquidity horizon definition for risk factors.

Endogenous Risks impacts on the banks portfolios should be incorporated in two ways: i) By lengthening of the liquidity horizon buckets they would fall in and hence attracting a larger capital risk charge ii) Widening of the liquidity bid-offer assumptions for liquidations of such positions. We do not support the concept of adjusting portfolio valuations to account for endogenous risks because they once again open the issue to wide variations between banks and also can result in difference in valuations on same securities across different financial institutions.

Overall, we believe that this is a crucial corrective step in the regulatory overhaul and the operational difficulties while understandable can be minimized by standardizing some of the factors for banks to avoid spending time to devise variations of regulatory interpretation to minimize the capital charges.

- **Treatment of Hedging and Diversifications:**

Table 3 on page 27 nicely summarizes the pros and cons of the different approaches. We are of the view that fundamentally speaking for regulatory regime which is not concerned about any bank's profitability but rather safeguarding the banking sector as a whole, uniformly and level playing field between banks on capital costs for hedged portfolios should be the highest priority.

If we consider this as the key underlying principle support the concept of floor to the diversification benefit as a reasonable recommendation. The key justification, we believe for Basel to put forward is that every crisis brings along with it the breach of historic ratios and relationships hence any level of portfolio diversification should have a floor up to which the banks can benefit from diversification benefits in reducing market risk capital charges.

- **Revised Models-Based Approach:**

Recommended process of internal models based approach for desk models goes into some detail on P&L attribution analysis and backtesting assessment. Both of these are valid improvements over current regime. However, we are concerned on these recommendations for two reasons:

  - This will pose a major technical challenge to regulators.
  - Secondly, most exotics and complex products have significant non-linearity in the risk factors as a function of level of underlying and require re-calibration in case of large stress moves. Hence, the concept of P&L attribution analysis while can explain the BAU but these models usually result in significant variations and unexplained P&L under stress moves. Hence, we recommend that in addition to the BAU P&L attribution the models should a stress testing requirements also that should be met before allowing for the model based approach.

We have reviewed the remainder of the material and feel that the remainder of the issues started to delve in the details of calibration process for the ES measures. We don't have any significant comments on the issues other than what has been covered in our views above and is applicable again to the issues presented later in the paper.

- **Conclusion:** Overall we believe that the most significant issue in the whole overview is the discussion on trading vs banking book boundary. Once regulatory oversight is able to get over the hurdle of identifying instruments based on market risk then most of the remainder of regulatory regime definition will follow in due course and will be refined with time.

BANK # 7

- **Paragraph 3.2.1, Page 20- Moving to expected shortfall**

The current framework's reliance on VaR as a quantitative risk metric stems largely from historical precedent and common industry practice. This has been reinforced over time by the requirement to use VaR for regulatory capital purposes. However, a number of weaknesses have been identified with VaR, including its inability to capture "tail risk". The Committee therefore believes it is necessary to consider alternative risk metrics that may overcome these weaknesses.

Bank Comments:

The expected shortfall approach is considered as a better measure than VaR as it factors in tail risk and is mathematically superior to VaR. But, despite its shortcomings, VaR has been the industry practice since 1990s and is widely used and well understood by the market. Expected Shortfall also has significant modelling risk as it entails modelling outcomes that are rare, which results in more complex modelling and backtesting procedures than VaR. Moreover; like VaR, ES is also based on historical data and therefore may be of limited use in predicting an uncertain future.

- **Paragraph 3.5.3, Page 26- Floor (or surcharge) based on the standardised approach**

As a final step, the Committee is considering the merits of introducing a standardized floor (or surcharge) on the regulatory capital that is generated from banks' approved internal models (ie the total regulatory capital associated with trading desks that are deemed eligible for modelling).

Bank Comments:

In bank opinion placing a floor on the capital charge under IMA will be considered as a disincentive for the banks which are continuously endeavouring to improve their market risk management architecture. Against this backdrop banks might be reluctant to further invest money and resources in acquiring state of the art solutions for market risk.

- **Paragraph 1.1, Page 8- The role of the regulatory boundary**

The Committee believes that its definition of the regulatory boundary has been a key source of weakness in the design of the current regime. A key determinant of the boundary is banks' intent to trade, an inherently subjective criterion that has proved difficult to police and insufficiently restrictive from a prudential perspective in some jurisdictions.

Bank Comments:

The document suggests two methodologies for regulatory boundaries – Trading evidence based and Valuation based. While the trading evidence based approach appears to be more practical but it is very onerous due to:

- Banks would be required to set and enforce limits both on instrument and risk position basis.
- Banks would monitor market liquidity level and specify expected holding period for instruments with potential penalties if that period is exceeded.
- It is required that banks should have a formal policy for describing what instruments should be held in the trading book.
- Internal control functions should conduct on-going evaluation to assess whether bank's instruments are properly assigned.

In our opinion, implementing such an arduous requirements will be a task for the banks with small trading books. Some leeway should be given to banks with smaller trading book or it should be left to the local regulators discretion to relax some of the requirements.

- **Paragraph 3.3.2(1), Page 22- Varying liquidity horizons in the regulatory market risk metric**

The concept of varying liquidity horizons was introduced into modelling requirements as part of the July 2009 revisions in the context of the IRC and the CRM. The Committee is considering a refined version of this concept for the trading book as a whole to capture market liquidity risk in a more comprehensive manner.

Bank Comments*:*

It is not clear whether the proposed set of amendments will be overriding all the previous requirements on IRC and banks are no more required to calculate IRC separately?

BANK # 8

We present below first some general observations on the paper and then answers to the specific topics where the BCBS has requested comment (excluding topics 5 – 8, which relate specifically to the Internal Model-based approach).

- **General observations**

We agree with the overall aim of the paper and the work stream it relates to, in particular improving the coherence of the trading book regime. However, we would observe that the initial hypothesis – that the previous Basel II approaches resulted in inadequate capitalization for market risks – whilst certainly true for many banks with large and complex trading book exposures, particularly those using the internal models based approach, is not uniformly true. Bank's capital position, including for trading book risks, remained satisfactory throughout the recent crisis. No doubt many other smaller, prudently managed banks, including all or most of the banks in the Kingdom of Saudi Arabia, had an experience more similar to ours than to that of the large international investment banks.

One of the most significant changes proposed in the document, is the abandonment of VaR based capital models in favour of adopting an Expected Shortfall approach. It is argued that VaR approaches under-estimated capital requirements and ignore tail risk. In our view from a theoretical point of view the VaR approach is robust – to specify at a given level of confidence an adequate amount of capital for a bank to survive. The issues with the VaR approach, relate to its implementation – inadequate holding period assumption, use of benign recent historic data, under stated correlations et cetera. Many of these implementation issues have been addressed in Basel 2.5 and the proposals in this paper would lead to further erosion of these problems.

Switching to Expected Shortfall does not, in our view, in any way reduce these implementation issues or model risks and has the disadvantage of moving from a philosophically clear position – essentially that bank X must have sufficient capital to be able to survive a stress Y – to a rather less clear notion that, if a stress of at least Y occurs, bank X must be able to survive on the (probability weighted) average. In our view it is preferable to remain with VaR and address the implementation issues, rather than switch to Expected Shortfall and paper over some of the model risk, simply because Expected Shortfall returns a higher capital requirement.

We note that the paper presents initial policy proposals and will follow with interest how these develop.

- **Specific areas where comment is invited in the BCBS document**

- **The boundary option**

Whilst we see merit from a theoretical point of view in the valuation based approach, we believe continuing to incorporate trading intention, albeit with increased objective criteria, is important and for this reason support the boundary option 1, the trading evidence-based approach.

We would caveat that in the local and regional context, certain instruments may not easily meet tightly drawn criteria. We await more specificity in this regard but would caution against a system that is overly rigid and that may have unintended consequences in terms of incentives for local banks to manage their risk in e.g. locally issued securities.

- **Likely operational constraints with the Committee's proposed approach to capturing market liquidity risk including the endogenous component**

We agree with the BCBS that the liquidity of market risk instruments is insufficiently captured under both the original Basel II and the new Basel 2.5 regime. From the point of view of our own product set and an expectation that the standardized approach would set clear criteria for bucketing instruments by perceived liquidity, we do not perceive significant operational constraints. With regard to the endogenous component of liquidity risk, we would suggest that if boundary option 1 is selected, it may be possible to frame this in such a way as to require positions carrying significant endogenous liquidity risk to be excluded from the trading book.

- **The proposed regime to strengthen the relationship between the standardised and internal models-based approaches**

We concur with the thrust of the comments on the standardized approach – that its shortcomings have been minor compared to the leeway given to banks perceived as more sophisticated in applying the internal model method. We tend to agree that the disparity in the range of capital charges under the various methods should be reduced and that there is merit in all banks calculating capital requirements on a standardized basis periodically and / or the standardized approach being used as a floor or other anchor point for the IMM approach.

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

In our view the partial risk factor approach meets the key objectives of the standardized approach better, primarily because in our view the standardized approach should remain straightforward with minimal reliance on internal pricing models.

The fuller risk factor method has theoretical merit and may be appropriate for banks with larger trading operations and infrastructure but, in our view, results in a significantly increased burden on banks and regulators to calculate capital requirements that may make successful implementation for all banks in all jurisdictions difficult.

We note the BCBS have said they do not intend to implement both approaches and thus give banks three alternative trading book capital regimes.
However, we would recommend this decision is revisited. The fuller risk method has merit as a step between a standardized approach and the internal model approach and in particular, to the extent the BCBS has longer term aims to phase out internal models based approaches either for particular banks or businesses within banks or more generally, the fuller risk method would appear a good contender as a replacement.

- **Amendments to the approaches**

Both possible standardized approaches seem to place significantly more weight on diversification benefits. This sits somewhat incongruously with one of the general themes of the paper – that in times of stress diversification benefits proved illusory. We would recommend considering a very straightforward standardized approach with little or no diversification modeling as a base approach.