



Standard Bank's response on the: Fundamental Review of the Trading Book

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

We do not believe either option is entirely appropriate, where a more fundamental review should be undertaken.

The **"trading evidence"** approach would result in the banking book being tainted with actively traded positions classified as banking due to insufficient evidence being available at the initiation of the trade. This in particular would have an onerous impact on Emerging Market banks - though the intention may be to trade, the trading desk may be unable to provide sufficient "trading evidence" due to the developing nature of the market.

The issue would be compounded by the proposed restrictions on transferring positions between the trading and banking books. If trading evidence later becomes available as the market develops and the intent was always to trade, then a reclassification from banking to trading is entirely appropriate.

The **"valuation"** approach would introduce positions into the trading book which are not actively risk managed, and market risk measures and expertise would not be appropriate for capturing the risk.

We believe that the only truly appropriate method of addressing the concerns raised by the Committee would be to remove any incentive for regulatory arbitrage by properly configuring the capital requirements in both the trading and banking books such that the identical risk is subject to the same correct capital treatment in either area.

Notwithstanding the above statements, we believe that the "trading evidence" approach is the preferable of the two options. The disadvantages of the "valuation" option (i.e. shoe-horning banking book instruments such as equity investments into a trading management framework) are more detrimental than those of the proposed alternative. Furthermore, the "trading evidence" approach is more in line with current industry practices and therefore would be less disruptive to implement (though this may not be true for smaller banks, particularly in Emerging Markets, where the "valuation" based approach may be preferable as it would require less sophisticated controls to implement and maintain).

It is suggested that the proposed restrictions on permeability of the Trading Book / Banking Book should be amended to allow legitimate transfers of positions where fundamental changes to market conditions have occurred.

It should however be noted that it is difficult to fully evaluate the appropriateness of the two different approaches in isolation to other proposed changes to the regulatory regime currently being discussed.

2. What are commenters' views on the likely operational constraints with the Committee's proposed approach to capturing market liquidity risk and how might these be best overcome?

Existing systems are geared for a static and uniform holding periods (one day or ten day). The proposal would result in significant reengineering of the existing systems and additional costs.

Assessment of liquidity for OTC products on an ongoing basis would be extremely challenging for small firms which do not have visibility of the flows in the market when this information is not available in public domain, eg – liquidity in FX spot markets.

The other option of using scaled one day shocks does not lend itself to full revaluation as it does not provide for a suitable mechanism of scaling the cross effects when the risk factors have different time horizons. (e.g. in the case of Quantoed products where the vanilla underlying has a different holding period to the FX rate, by what measure would the P&L from the correlation between the two risk factors be scaled?)

Many products are sensitive to more than one risk factor. Having different horizon per risk factors will not generate realistic data sets for full revaluation pricing.

It is not possible to have consistent horizons at risk factor level and at asset class level. In any case, having a non-unique horizon creates a major challenge in terms of aggregation and consistency. The analytical interpretation of these computations at aggregated level with mixing of different horizons will be extremely difficult, if not impossible. This defeats the “use case”, and makes backtesting impractical. Backtesting will also not provide meaningful answers from a statistical point of view

3. What is the commenter’s view on the proposed regime to strengthen the relationship between the standardised and internal models based approaches

We believe that there are significant downside impacts should the relationship between the standardised and the internal models approaches be strengthened too far.

- Banks will have far less incentive to invest in internal modelling going forward (especially if the floor is set at too high a percentage of the standardised approaches);
- There will be less benefit in hedging of risk ;
- The implementation of maintenance of the standardised approach for all portfolios would result in significant operational costs.
- Resources will be diverted to regulatory reporting instead of managing and controlling market risks.

To maintain both an internal model and a standardised calculation for all trading portfolios will incur significant project costs and of greater concern, a significant increase in “run-the-bank” costs. Market Risk managers will be required to produce standardised numbers on internal model approved portfolios which will not have any tangible benefit for risk management or capital requirements. This will distract resources away from looking at the actual risks the business is exposed to.

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?

The approach to model approval should be based on the products (and the system infrastructure on which these products are risk managed) within an asset class as well as ensuring the risk factors associated with each product are captured correctly by the internal model. Using a trading desk level to model approval may not lead to a level playing field as firms can define their trading desks differently. Furthermore, consideration needs to be given to how internal trades between desks

that are approved and those that are not are handled. Additional complications such as when a trading desk conducts activities qualify for both internal model approval as well as those that do not can arise. In the event that the trading desk level to model approval is implemented, there needs to be a linkage between a trading desk and the overall trading business – a quantitative materiality threshold is required.

With respect to the examination of the profit & loss attribution (“PLA”), more details of the calculation of “risk-theoretical” P&L is needed. There may be instances where for certain products that the “risk-theoretical” P&L is nonsensical depending on the calculation methodology. With respect to back-testing exceptions, both the magnitude and the frequency of exceptions need to be taken into consideration, with emphasis on the former.

Regarding FX and Commodity positions in the banking book, the rationale for the positions residing in the banking book must first be established. Thereafter the treatment, be it internal model method or standardised rules, can be determined. We think it is appropriate that the rationale should determine the treatment and not vice versa. However, as a general principle we do believe that the capital treatment of the same economic risk should not differ materially between banking book and trading book.

Systemic case will be greatly increased. Most desk are likely to face back testing problem in period of sustained stress. Withdrawing the model permission at the same time for all the desks in different banks will simply accelerate the crisis.

Finally, a grace period to allow firms to investigate and respond to “unacceptable” PLA and back-testing is required.

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?

The process of identifying a stress period by using a full set of risk factors (i.e. the “direct” method) would result considerable strain on both people and IT infrastructure to implement and maintain.

The results from the “direct” method of calculation would not necessarily be significantly more robust than the “indirect” method (i.e. using a reduced set of risk factors representative of the portfolio) as there would be an ever increasing number of instruments that would need to be proxied given that they were not in existence for the full history of such a large time window (for example, on-the-run debt securities).

In addition, assuming that the “direct” method would only be run periodically (as opposed to “daily”, the outcome of the calculation would be entirely dependent on the portfolio make-up as of the particular of running and may not be reflective of the ongoing nature of the portfolio. This would be particularly true when business plans are changed as there is no room for discretion in picking up / dropping risk factors depending on their importance in the new business plan. The “indirect” method however would be more able to be run more frequently and therefore would be more sensitive to changing portfolio composition.

For these reasons, it is our opinion that the “indirect” method would be the most practical approach, permit qualitative adjustments for picking up the stress period in light of changing business plans and provide a better cost-benefit return.

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

The desk based approach naturally fits within the framework of organisations as it ties the capital usage with the P&L. Risk factor based approach would present institutions with management conflicts as no single desk is usually responsible for all the risk of an institution in a risk factor or asset class.

The desk based approach would also need lower investment in infrastructure to implement than Risk Factor based approach.

The Committee's proposed indicators in Section 4.2.2 to identify a desk assumes that desks trade either internal model ("IMM") qualified products or non IMM products. In reality, desks trade both types of products. Hence, the indicators have to be defined such as to avoid forcing institutions to create two desks in the place of one in order to fulfil these requirements.

In case of transactions which price using multiple risk factors, it would be difficult to implement constrained correlation across risk factors in a full revaluation mechanism as this would have to feed into the cross terms. This would involve substantial reengineering and could complicate the pricing of products.

With respect to the risk factor based aggregation method proposed, consideration needs to be given to a particular firm's trading strategy as a one size fits all approach to determining the correlations across all asset classes is not appropriate across all firms. Consideration needs to be given to the most representative risk factors in a particular asset in order to determine the correlations. Furthermore, guidance on the frequency by which the correlations are reviewed and updated needs to be given

The "use-case" is very important as is the desk based view. Creating a perfect top down view of the bank's risk by risk factor may be good from a regulatory perspective, but will lead to poor management.

- The people primarily in charge of the risk will not be connected to what is reported at the regulator's level.
- The risk factor view may be very misleading, as cross-risk, correlation effect may not be well represented by a simplistic risk factor view.
- The centralisation of risk means a possible dilution of responsibility, with little accountability.
- Once the link between Risk and P&L is broken, no serious risk management can take place.
- Market risk at desk level should be managed in conjunction with the P&L analysis and with the other risk: Operational, Credit...etc.

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)?

The elimination of the patchwork of overlapping capital charges is an important objective, and therefore we believe that an integrated model is vital in order to realistically capitalise the market and credit risk modelling.

The challenges identified by the committee are:

- *Defaults & migrations are low probability events:* The ES model should be capable of differentiating between continuous and discrete risk factors – only the continuous risk factors should be subject to backtesting.
- *Survivorship bias makes calculating the correlation difficult:* There is a similar problem with the current IRC approach for models which rely on correlation matrices. The regulator should specify the correlation parameters to overcome this and ensure level playing fields.
- *Model complexity reduces the supervisability of the framework:* We do not believe having a separate model will lead to any tangible reduction in the overall complexity of supervision. The economic risk remains the same and the regulator must be in a position to adequately determine that this risk is correctly capitalised regardless of what model is chosen. Furthermore, the regulator has full visibility of all models used and should have sufficient expertise in order to fully evaluate the appropriateness of the model.

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?

Moving from VaR to an Expected Shortfall model would require additional investment in system infrastructure and the development of new diagnostic tools for the calibration of models and input parameters (such as the proposed liquidity buckets).

Should too many distortions be introduced into the model (such as artificially constraining diversification), then two sets of backtesting would be required (one for internal purposes against a “purer” version of the model, and the second for regulatory purposes). This would result in duplication of work, and a break in the “use-case”

The capital would become a function of two models – the model for generating P&L distributions and another for calibrating the distribution of the tail. The interaction of the two models is not fully understood in a practical context.

One other concern is that the modelled Expected Shortfall is unlikely to be widely understood outside of the Market Risk department, especially given the distortions introduced by including liquidity horizon adjustments and artificially reducing correlations – this would undermine the value of the model to senior management and reduce the usability of the results.

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

Further and more granular details are required on the exact workings of the two proposed alternatives (i.e. “partial risk factor” and “full risk factor”) before a full comparison between the appropriateness of the approaches can be made.

However, both the proposed alternatives appear to be significant improvements over the current standardised approach.

We believe that the partial risk factor approach better meets the Committee’s stated objectives and would be more practical to implement.

The objectives of the Committee for revising the standardised model are set out below:

- 1) *Improved risk sensitivity application (provide prudent recognition of genuine hedging)*
Both approaches would provide this, though the full risk model approach seems to meet this objective more clearly given that it is the more pricing model focused
- 2) *Credible (clear, simple and logical)*
The partial approach is both simple and should be easier to implement,
- 3) *Limited model reliance (not be pricing model dependant)*
This is clearly better fulfilled by the partial risk factor approach which has limited model reliance in comparison to the full risk factor approach which is reliant on the bank's pricing models.
- 4) *Credible fallback (must act as a back-up for business mode out of IMM)*
One would see the partial risk factor approach as a more robust fall back than the full risk factor approach given that it has less reliance on pricing models and can be implemented more simply.

In summary, given the above responses the partial risk factor approach better meets the objectives of the committee.

10. Do commenters propose any amendments to these approaches?

Overall:

The proposed overall approach is not practical, being mostly theoretical and "Top Down" oriented. Centralisation of the risk by asset class and allocation of different holding period is the wrong answer to a real problem. It is the wrong answer because it disconnects the risk management at the desk level, where Risk and P&L must be analysed together, in conjunction with credit risk and operational risk.

The proposed approach is overly theoretical and will make back-testing impractical, and risk measurement too far from reality to really be used on a day-to-day basis (therefore undermining the "use case"). We would rather suggest a framework based on a Stressed VaR, with a unique holding period of a month if 10 days is deemed too aggressive, complemented with some regulatory defined stress scenario, as a floor.

Liquidity:

The liquidity in some markets (especially EM bond markets) cluster around events such as auctions, central bank operations, etc as most participants are buy and hold investors. This is complicated by the fact that the events are reasonably ad hoc in nature and do not occur in line with a predetermined calendar – the liquidity parameters should explicitly take these events into account.