

Consultative document – Fundamental review of the trading book, BCBS219

Standard Chartered Bank thanks the committee for an opportunity to respond to the consultation. The questions put in the consultative document are answered in this response.

Key messages

Standard Chartered welcomes the initiative to apply lessons learned from the crisis and the objective to ensure more level global standards.

We support a globally consistent definition of the trading book / banking book boundary and the move to expected shortfall as a standard way to capture tail risk in models.

The failure of some banks to capitalise against market illiquidity is recognised, but we see a danger that risk measures will become difficult to test objectively. They will also be subject to modelling uncertainty if differing liquidity horizons are reflected in a portfolio level measure.

While diversification is a feature of sound risk modelling, basis risk can be missed and so we welcome the tighter supervision of model performance i.e. at sub-portfolio level, as well as the conceptual move to align standard rules and modelled capital. We warn that prescribed correlation can lead to poorer risk management as a result of mis-alignment between risk and capital measures: further we believe that it is not possible to prescribe correlations that are conservative for all portfolios.

Industry has proposed a smooth transition between modelled and standard rules capital, dependent on model performance and encompassing the proposal for granular model approval. The transition approach (standard rules capital surcharge) retains the principle of motivating improvement of risk measurement standards and so we support it over the use of a capital floor which would misalign capital efficiency and risk management. Further the committee is encouraged not to underestimate the implementation effort required, even for the partial risk factor approach.

Standard Chartered is already subject to granular model approval, so we support this in the spirit of raising global standards.

Finally, we welcome the transparency shown so far in the approach to calibration of standard rules capital and look forward to further collaboration in the design of the calibration algorithm.

Conclusion

Standard Chartered recognizes the amount and quality of work that has been performed by the Trading Book Working Group, and looks forward to working with them to assist achieving a final publication reflecting sound principles, with a practical and feasible implementation so that the objectives are achieved without threatening economic well-being.

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Fundamental Review of the Trading Book

- High Level Principles

We summarize the principles we think should guide regulatory change following the events of the 2007-2008 crisis. To set the scene we first recall the causes of the crisis. Then a set of principles are stated. In a later section we apply the principles to answer questions put in BCBS219, the Fundamental review of the trading book Consultative document.

The Causes of the Crisis

Significant losses made during the crisis stemmed from so-called ‘trading activities’¹. The knock-on impact of these losses sparked a global economic crisis and naturally led to a broad-based discussion on which trading activities banks should engage in, how these should be governed and what the appropriate capital requirements are.

It should be remembered that trading losses stemmed almost exclusively from synthetic illiquid securities, such as asset-backed securities, sub-prime portfolios or collateralised debt obligations. Other trading areas such as FX, interest rates, commodities or equities generated few, if any, significant losses in spite of severe market volatility.

While maturity transformation is a function normally effected through the banking book, bank losses in the crisis were mainly crystallized in trading books. In general, trading books are intended to hold liquid assets that can be bought, sold or hedged intraday. However, a major contributing cause to the crisis was that some banks warehoused more and more illiquid risks on trading books. This was compounded by unregulated ‘shadow banks’ such as SIVs, hedge funds and other off-balance sheet vehicles which built large portfolios of synthetic illiquid securities funded mainly short term from either banks or capital markets.

The largest category of synthetic illiquid securities comprised ABS, CDO and subprime loans which were typically funded using short-term liabilities such as commercial paper or overnight borrowing. There was a general flawed assumption of guaranteed access to liquidity, reflecting poor discipline in managing funding risk and in assessing asset tradability.

The mis-match of short-term funding of synthetic illiquid securities was magnified further by poor discipline in managing the boundary between trading and banking books. By allocating structured credit products to trading books, some banks gained favourable capital, accounting and most importantly liquidity treatments which increased the perceived profitability of these businesses thereby enabling a gargantuan growth of these assets.

As a result of this poor discipline, maturity transformation was passed to trading books which were never designed to appropriately identify, manage or capitalise the inherent risks in this.

High Level Principles

Standard Chartered welcomes the initiative to apply lessons learned from the crisis and the objective to ensure more level global standards.

In determining the appropriate balance between macro- and micro-regulation, policy makers must take into account the complexity of underlying businesses. They should strike a balance delivering financial stability whilst properly incentivizing banks to provide trading services which support the global economy. We advocate the adoption of the following principles;

[A] Regulation should be principle-based, rather than a rule-based.

Principle-based regulation will enable regulators to keep pace with financial innovation and prevent specific rule-based arbitrage.

Wherever possible, existing regulations should be fully utilised.

¹ See Annex 1, Table 6, p58 of BCBS219.

[B] Regulation should facilitate global harmonization of guidelines, implementation standards and timeline

Today's global financial markets have reached a complexity where no country can insulate itself from developments elsewhere in the world. This necessitates a global policy response to the current crisis. A global response would also help to decrease regional regulatory arbitrage as well as facilitating the supervision of globally active banks.

There have been some efforts in the direction of regional harmonization such as the EBA guidelines on recent market risk regulatory changes.

However we are still far away from real global harmonization. For example the US is still not on Basel 2.5 which was introduced at the end of 2011 across Europe.

Standard Chartered is already subject to granular model approval, and we support this approach to model approval in the spirit of raising global standards.

[C] Guidance must articulate a clearly delineated and consistent framework to address liquidity.

Much of the crisis was due to banks holding synthetic illiquid securities products in the trading book, without appropriate risk measures, management or capitalization. Fair value treatment of instruments that would be held to maturity exacerbated the impact of losses in the short term.

The failure of some banks to capitalise against market illiquidity is recognised, but we see a danger that risk measures will become difficult to test objectively and subject to modelling uncertainty if differing liquidity horizons are reflected in a portfolio level measure.

[D] The regulatory framework should include central assessment of systemic risk.

Regulators should assess concentrations of risk across the banking industry in order to identify systemic risk. Policies could be based on risks stemming from leverage, maturity mismatch, Level 3 assets, and rate of business expansion. Standard reporting is being introduced which will facilitate such an assessment.

We are supportive of macro-prudential regulation (MPR). Lessons from financial crises show that MPR is most effective where it helps policymakers to lean against potential bubbles with counter-cyclical tools that reduce the probability, length or severity of an economic downturn. In the case of financial services, macro-prudential tools should be used where there is an industry-wide collective action problem and not where more targeted firm-specific micro-prudential or supervisory tools can be used.

We encourage policymakers to find tools that reflect economic activity and not simply legal form. For instance, in seeking to address a retail credit-fuelled bubble the application of loan-to-value or loan-to-income caps is likely to be effective because it will lower leverage, restricting unsustainable credit growth in the system, regardless of whether credit is provided by a lender that is UK regulated or passporting into the UK under an EU passport. Equally, it would be inappropriate, for example, to apply restrictions on direct lending on first charge residential mortgages (which are regulated in the UK) and not on buy-to-let mortgages (which are unregulated), not least because the growth of the buy-to-let sector is likely to have a more pronounced effect on asset bubbles developing and was certainly the case during the recent crisis. Over the last twenty years a significant amount of trading risk has been assumed by unregulated market participants, including hedge funds and special investment vehicles (SIVs). Although not regulated these entities were fully integrated into the global financial system through their dealings with banks. For example hedge funds relied on banks to provide their funding requirements, in times of stress this resulted in large interdependencies and systemic risk. These systemic risks were not properly identified or governed and contributed to the growth of leverage in the subsequent size of the unwinding problem.

[E] In addition to providing a financial buffer, capital requirements should represent incentives to;

- develop risk management tools and measures
- hedge risk
- recognize current and potential basis risk as a result of hedging
- monitor risk measurement performance

The removal of model approval and capital penalties for under-performing models should be a realistic option, not only available but used.

The industry has proposed a smooth transition between modelled and standard rules capital, dependent on model performance and encompassing the proposal for granular model approval. The transition approach (standard rules capital surcharge) retains the principle of motivating improvement of risk measurement standards and so we support it over the use of a capital floor which would misalign capital efficiency and risk

management. Further, the committee is encouraged not to underestimate the implementation effort required, even for the partial risk factor approach.

[F] Capital models should be based on measures which are “objectively testable” over time.

While theoretical arguments may have appeal to some, our view is that they are worth nothing without empirical testing. Models should be transparent, use empirical based calibration and be subject to back-testing at a level below that used to drive the capital model.

We advocate avoidance of modelling concepts that introduce a lot of model dependence e.g. the modelling of dynamic hedging or other future trading behaviour, rollover of liquidity horizons, high percentile-long horizon measures.

While diversification is a feature of sound risk modelling, basis risk can be missed and so we welcome the tighter supervision of model performance i.e. at sub-portfolio level, as well as the move to align standard rules and modelled capital conceptually. We warn that prescribed correlation can lead to poorer risk management as a result of mis-alignment between risk and capital measures. Further it is not possible to prescribe correlations that are conservative for all portfolios.

[G] Standard rules capital should evolve following transparent calibration of risk weights.

Standard rules capital is important to all firms, large and small and will become increasingly important if used as a surcharge, or capital penalty for underperforming models. Transparency in the calibration of risk weights allows scrutiny, leading to a robust process and appropriate levels across the industry serving the requirements of regulators and market participants alike.

We welcome the transparency shown so far in the approach to calibration of standard rules capital and look forward to further collaboration in the design of the calibration algorithm.

Fundamental Review of the Trading Book

- Answers to Questions

Questions taken from BCBS219

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

We believe that a trading evidenced-based boundary would better address the weaknesses identified with the current boundary because the alternative relies on accounting standards which show regional variations. Most importantly, the boundary must be very clearly defined and consistently implemented and supervised. For the purposes of discussion, we list possible policy statements in Appendix A.

Principles [A] and [B].

Extending the specific point raised in Q1, we note that under Basel 3, all financial instruments that carry market risk will have the same capital implications and that this will be unrelated to trading intent, evidenced or otherwise. This is recognised as a motivation for the BCBS suggestion to introduce a valuation-based boundary (VBB).

However, as acknowledged in the consultative document, the VBB would spread a wider net over the set of financial instruments subject to market risk capital treatment including some that a bank cannot trade or will not have intent to trade. Whilst recognising that such instruments should attract a market risk capital charge, it confronts reality to consider them part of the 'trading book' and assign a Pillar 1 market risk capital charge.

Standard Chartered supports the need to address consistency of capital treatment of IRRBB in the sense of geographical harmony and also across the trading book / banking book boundary so as to avoid arbitrage. We look forward to working with the appropriate regulatory working group on this issue.

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?

We support the industry proposal expressed in the ISDA/GFMA/IIF response to address liquidity through a capital charge for the cost of exit of positions with illiquid risk factors within a specified liquidity horizon. A modelled approach would introduce model uncertainty and a measure that cannot be directly and objectively tested.

Principle [C]

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

We support prudent recognition of hedges under the proposals for standard rules capital so that "model disapproval" is a feasible option for local regulators. This change promotes level global implementation standards.

Principles [B] and [G]

4. What are commenters' views on the Committee's proposed desk-level approach to achieve a more granular model approval process, including the implementation of this approach for banking book risk positions? Are there alternative classifications that might deliver the same objective?

We support moving to a more granular model approval process because this change is aligned with the principle of achieving level global standards.

As an alternative to a standard rules floor, we suggest that the capital charge be the sum of portfolio model based capital², a fraction of standard rules for desks with sub-optimal model performance and standard rules for unapproved desks. This alternative achieves the same objective while avoiding dis-incentivising firms from development and maintenance of accurate risk assessments.

Principles [B] and [E]

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?

An indirect approach is more practical and has the advantage of retaining a link between current expected shortfall and capital requirement.

A direct approach at entity and desk level would be a significant challenge in particular for less advanced firms.

Principle [E]

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?

We warn that prescribed correlations will lead to poorer risk management as a result of mis-alignment between risk and capital. Allowance of a fraction of model diversification is practical, provided there is a standard method for disaggregation e.g. into asset classes with well defined asset classes.

Principle [E]

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 (e.g. the choice of the quantile parameter for ES, the P&L attribution and back-testing processes, etc)?

Capital models should be built from risk measures that are appropriate to the risks considered. We prefer global multipliers to the use of measures that cannot be objectively tested e.g. very high percentile and long horizon.

Principle [F]

Regarding interaction between market and counterparty risk, the Committee has chosen to exclude proposals for credit valuation adjustment ("CVA"). The CVA capital charge is clearly a key element in the overall capital held for risks in the trading book. However, the Basel III framework on CVA capital charge is flawed both in its design and in the calibration between the two approaches allowed for the calculation of the charge. Further consideration is essential to avoid unintended consequences. Alternatively, we suggest that a separate review of the CVA framework is set up as a matter of urgency.

8. What are the likely operational constraints with moving from VaR to ES, including any challenges in delivering robust back-testing, and how might these be best overcome?

We are supportive of the move to ES in order to capture tail risk in a globally standard measure. We think that a lower threshold than 99% confidence level is advisable so that; the statistical uncertainty in estimation is not larger than variations due to change in risk profile; meaningful tests can be performed over a recent period (e.g. 1 year, repeated quarterly); extreme model dependence is avoided as would be the case for a very far tail measure.

Some development is required to incorporate non-VaR type tail risks and to develop reporting and explain around ES but we think this is feasible.

² A measure that could include unapproved desks (at the bank's discretion) so as to avoid split hedges or facilitate implementation. The double counting within a single model risk measure in this case is acceptable i.e. paying both modelled and standard rules charges.

Principle [F]

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

We recommend the partial risk factor approach as the alternative full risk factor approach may be unworkably complex for small firms to implement. The committee is encouraged not to underestimate the implementation effort required, even for the partial risk factor approach and we encourage clear disclosure of the balance between modelled and standard rules capital.

We welcome the transparency shown in the approach to calibration of standard rules capital so far and look forward to further collaboration and also engagement needed to interpret the intention for upcoming Quantitative Impact Studies.

Principles [E] and [G]

10. Do commenters propose any amendments to these approaches?

If the modelled approach to liquidity is taken, we suggest allowance of different scaling laws when scaling one-day shocks to derive long horizon risk factor shocks (Annex 4, Section 3). This is because risk factors are observed not to grow like the square root of time. And to have different growth laws by asset sub-class e.g. Equity price, Equity implied volatility etc.

Principles [C] and [F]

Industry has proposed a smooth transition between modelled and standard rules capital, dependent on model performance and encompassing the proposal for granular model approval. The transition approach (standard rules capital surcharge) retains the principle of motivating improvement of risk measurement standards and so we support it over the use of a capital floor which would misalign capital efficiency and risk management.

Principle [E]

Appendix A – Policy Statements for Discussion

Trading positions must have some or all of the following characteristics:

- Observable market prices.
- Value can be modelled with reference to observable market input parameters.
- Sufficient trading liquidity exists for the position.
- Market risk exposures generated by trading positions can be hedged or otherwise risk-managed.
- Positions are hedges for other elements of the trading book.
- There are no (regulatory, contractual, etc.) restrictions on the Bank's ability to sell, or at minimum hedge, the position.

Trading can be inferred from the presence of some or all of the following factors:

- Position is held in a part of the business that normally manages trading positions.
- Position is captured in trading systems that allow for mark-to-market and exposure management.
- Position is captured in risk systems that allow for proper aggregation, monitoring, analysis and control.
- Position is designed to create trading exposure or capture an arbitrage opportunity (where downside is protected), or is held for resale.
- Position is not held as a hedge for a banking book position.
- Position is captured under trading limits that reflect the market liquidity.
- Position's funding commitment period is less than the position's term to maturity.
- There is proven ability or reasonably high expectation that the business can execute trading.

Furthermore, specific transactions must be reviewed for the following factors:

- Potential for a transaction to result in banking book exposure for Bank or any of its subsidiaries during the life of a trade. For example:
 - a client may unilaterally cancel part of a transaction that would result in a residual exposure that would not qualify for trading book treatment.
 - the bank may face performance, legal or other operational risk that would result in an exposure that would not qualify for trading book treatment. This could happen, for example, if a currency swap were re-characterized by a regulator as a separable loan and deposit.
 - the involvement of multiple booking entities in a transaction leaves (or potentially leaves) one or more subsidiaries with a standalone exposure that would not qualify for trading book treatment.
- Where accounting and/or other internal processes leave sufficient doubt that capital will be calculated consistently, the more conservative capital methodology will be applied.