BIS 83-008193
10 09 12

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Kind Regards,

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VTB CAPITAL plc: RESPONSE TO BCBS CONSULTATIVE DOCUMENT: FUNDAMENTAL REVIEW OF THE TRADING BOOK

1 This letter represents the views of VTB Capital plc ("the bank") on the Basel Committee on Banking Supervision ("BCBS" or "the Committee") Consultative Document 'Fundamental Review of the Trading Book' published on 31st May 2012 VTB is grateful for the opportunity to respond to the Committee's proposals on this important topic

2 VTB Capital plc is content for this submission to be published on the BIS website

3 The format of this response is some general observations on the proposals as a whole, followed by short responses on most of the individual questions summarised on page 89 of the BCBS document

4 By way of context, VTB Capital plc is the UK-incorporated banking subsidiary of VTB Group, a majority state-owned Russian commercial and retail banking group VTB Capital plc is authorised and regulated by the UK Financial Services Authority In recent years the bank has been establishing itself as one of the core entities in VTB's investment banking business, branded VTB Capital, which is undertaken across a number of entities globally including the bank, its sister company ZAO VTB Capital, Moscow (a licensed broker-dealer in Russia) and on the balance sheet of JSC VTB Bank The bank's principal business activities are advisory and capital markets business (labelled "Global Banking") and securities and derivatives trading business (labelled "Global Markets") which undertakes both client business and own-account risk taking in fixed income, equity, foreign exchange, interest rates and commodities The bank's business focus remains Russia, and the majority of the bank's business involves either or both of Russian-related clients and Russian markets However the bank is currently engaged in a strategic expansion of its business internationally, with the aim of distributing more Russian-originated and internationally-originated risk to international Emerging Markets dedicated institutional investors

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5 It follows that (a) the bank is still a relatively small participant in international financial markets at this stage of its business evolution, but is growing quite rapidly and envisages this growth to continue in the coming years, and (b) the bank has a strong Emerging Markets focus Both these factors are relevant in determining the bank's response to the BCBS Fundamental Trading Book Review

6 Our overall observation is to welcome the greater coherence of the approach outlined in the Committee's consultative document in particular the use of a single risk metric as the basis for both the internal models-based approach and as the basis for determining risk weights for the standardised approach Even though we acknowledge the single measure is a more 'stressed' risk output than has been used in the past for models-based capital, we welcome the return to a more coherent framework than the current 'Basel 2 5' aggregation approach which we think is unnecessarily additive and punitive from a market risk capitalisation standpoint, especially for Emerging Market underlyings Furthermore we are hopeful that the proposals, if implemented, may restore some connection between the models-based capital measures and banks' internal economic capital and risk metrics, which has always been a cornerstone of internal models-based capital approaches The credibility of external (regulatory capital) measures compared to internal (economic capital) measures has been severely stretched as a consequence of the portfolio aggregation approach required under the Basel 2 5 revisions, which, for understandable reasons, were aimed primarily at delivering higher capital levels for market risk via a conservative aggregation method, at the expense of coherence and internal credibility

7 In spite of the comments in the preceding paragraph, we consider that the proposals set out in the Committee's document are significant and far-reaching, and accordingly that they would need to be implemented very carefully, to ensure that two additional key objectives are met (on top of the overriding objective of strengthening capital standards for market risk and thereby contributing to a more resilient banking sector) In other words we consider that while the strengthening of capital standards is a laudable and necessary objective, it needs to be counterbalanced with additional objectives to ensure both fair implementation and ultimately a more resilient banking system in the long term

8 The two additional key objectives we consider important are
(I) Maintaining proportionality and fairness in implementation between organisations of different size, maturity and business focus, and
(II) Maintaining an appropriate relationship between the models-based approach, based on economic capital, and a more punitive standardised rules approach

9 With regard to proportionality and fairness it goes without saying that a level playing field will be required in implementing these proposals across size, jurisdiction and type of

organisation It is accepted that this would need to incorporate a fair consideration of market liquidity, alongside a considered approach to what the BCBS document calls the "endogenous" aspect of market liquidity However our view is that the comprehensive inclusion of market liquidity as a consideration in banks' regulatory capital requirements risks a blanket punitive approach to markets deemed externally to be "illiquid", which would likely have a disproportionate effect on banks whose business focus is primarily on Emerging Markets Our view is that a fairer and more relevant factor than the absolute level of market liquidity is the relationship between external or market liquidity and "endogenous" or bank-specific liquidity (i e relating to bank-specific portfolio characteristics such as risk concentrations) In our view, if risk concentrations are small then it matters less that the external or market liquidity to which a bank is exposed is low the ratio between them should be the input to market risk capitalisation, not the absolute size of either By construction, in our view, this kind of capital treatment is more appropriately dealt with under Pillar 2 than Pillar 1

10 With regard to the relationship between standardised rules and models-based capital we want to ensure that, in particular for Emerging Market underlyings where shock calibration may be more difficult due to perceived lower external market liquidity, there is appropriate calibration of the relationship between standardized rules and the models-based framework to ensure that banks do not have perverse incentives to adopt either approach Furthermore there should always be positive incentives for banks to make the necessary investment to enhance their risk management frameworks It is accepted there needs to be some redress by narrowing the gap between models-based capital and standardised rules but not to the point where positive incentives are eliminated

11 Summarised responses to the specific questions set out on page 89 of the BCBS document are attached as Appendix 1

12 Once again VTB Capital plc is grateful for the opportunity to participate in this consultation and we look forward to seeing the published responses to the Committee's proposals

13 Naturally we would be happy to discuss any of the issues raised in this letter with BCBS staff in more detail For information we are sending copies to our lead supervisors at the Financial Services Authority (Prudential Business Unit) in London, Chris Forster and Andy Mills

Yours faithfully,

Nick Hutt **Nick Joseph**

APPENDIX 1 <<<VTB Capital plc responses are shown in blue chevrons ***NOTE these draft responses are still under consideration as at 15th August 2012***>>>

BCBS consultative document 'Fundamental review of the trading book', 31st May 2012: extract, p.89

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

<<<We consider the valuation based-boundary may only be viable where same/similar accounting standards are universally implemented and adopted by all banks in similar timeframes. In the absence of this, strengthening the intent-based boundary through the trading evidence-based approach is the preferred option In addition to the detailed enhancement measures, reporting requirements could be set to capture information around post-inception reclassifications of positions (following movement across the boundary).>>>

2. What are the 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 regard this as a potentially significant operational undertaking, and one that could disadvantage smaller institutions with fewer resources to allocate to Initial categorisation and on-going administration. We would hope there might be scope for subjective classification, which might suggest this feature is better captured under Pillar 2 than Pillar 1 It would be Informative to see and understand the construction process behind any proposed regulatory flooring.

From a conceptual perspective we are not sure the proposals capture the fact that different institutions may be able to access different levels of liquidity in different markets >>>

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

<<<We acknowledge the value to regulators of requiring banks to maintain a periodic standardised rules calculation (allowing fallback if subsequently an institution's internal modelling is deemed inadequate)

No details are made available as to how a new flooring mechanism, based on standardised rules, might work The introduction of this floor potentially reduces incentives for financial institutions to invest in internal risk modelling

Finally we would wish to ensure an appropriate calibration of the difference between standardized rules and models-based capital for Emerging Market underlyings which might otherwise be penalised under either approach >>>

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

<<<A more granular, desk-level approach is reasonable Additional workload is likely where this is applicable to the banking book >>>

5. View on direct vs Indirect approaches to calibrating the framework to a period of significant financial stress?

<<<Under the direct approach, the mapping of approximations (of current risk to observable historical data), and searching over long periods of time, represent a significant undertaking and a major computational burden The indirect approach potentially offers a lower computation requirement but introduces scaling factor uncertainty

Institutions should be allowed to choose and justify their selection Worth exploring further the stated option of an hybrid approach, searching on a reduced risk factor set but once identified, applying full risk factor set and full model >>>

6. What are views on merits of desk-based and risk-factor-based aggregation mechanisms to constrain diversification benefits?

<<<We would need further information before commenting. For example, what is the process by which a supervisor will set the correlation parameter for cross asset aggregation? How often would this be revisited and on what basis?>>>

7 Robust supervision of integrated market and credit risk modelling? How would an integrated modelling approach affect other elements of proposed framework?

<<<We find it difficult to opine on this question due to a relative lack of experience. We think integrated modelling will represent a significant challenge for smaller institutions >>>

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

<<<At this stage our view is that, operationally, the mechanics of providing an Expected Shortfall number are similar to current mechanics If not already done, data scrubbing would have to extend beyond the prescribed confidence threshold Incorporating extreme tail loss beyond the prescribed confidence level would result in fewer back-testing exceptions We would welcome further guidance as to expectations of ES and back-testing configurations (for example: are we expected to look beyond the 95% or 99% thresholds?) >>>

Continuation

9 Which of the two approaches meets objectives for a revised standardised approach?

<<<It is difficult to take a position on this without more information as to the detail of both approaches (e g visibility to the regulatory risk weightings for the partial approach) Whilst we welcome an update to standardised rules, this should not be accompanied by total removal of incentives for institutions to develop and apply for internal model approval >>>

10 Amendments to these approaches?

<<<Not at this stage >>>