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Dear Ms Barger & Mr Adkins

## Comments on: Fundamental review of the trading book: A revised market risk framework

We thank you for the opportunity to provide comments on the revised framework document and have endeavoured to capture all the comments from our members to correctly reflect our concerns and understanding of the impact for the revised framework.

Our members support the industry representations made to the Trading Book Group in New York on December 10, 2013 and the subsequent written proposals.

### Executive summary

In general:

- We support the intent of the Trading Book Group (TBG) to more appropriately define the scope of the Trading Book and to more appropriately align capital to risk types within the trading book.
- In recognizing the importance in the QIS in calibrating changes of the significant contemplated, particularly with respect to the operational burden required to build the necessary infrastructure, we are of the view that several rounds of QIS would be prudent, with a minimum of a 1 year time horizon to complete the first round.
- We support the removal of the some of the double counting that occurred within the VaR/sVaR and IRC approach and the recognition of some diversification and hedging within the standardized approach.
- The Revised Standardised Approach is complex and we support the alternative of applying a fuller risk factor approach (as opposed to the current partial risk factor approach) so as to bring the model requirements closer to information already produced and validated by banks
- Notwithstanding the above, we believe that even a re-worked Revised Standardised Approach would be too complex a model for small emerging market banks to implement. As such, we propose that these banks, at the discretion of their national regulator, be allowed to use the existing Standardised Approach. These smaller banks would be affected by the Revised Standardised Approach through the consolidated supervision of their parent banks.
- The minimum multiplier of three could result in a large increase in capital under the new models if it is retained instead of being calibrated through the QIS process.
- We concur that if the standardized method is the calibration standard however, it does not make sense to also prescribe the IMA model. We feel that we should be allowed to look at

whatever model our regulator deems fit, but variations from the “floor” of the standardized model should be questioned / investigated, but that no formal floor should be specified.

- We are also concerned about the breakdown between the back-testing of the VaR model and the actual capital calculation. Back-testing the stressed ES (and on a desk/BU basis) will be extremely challenging

Our key concern:

We are not comfortable with the complexity in the new standardised approach as it will not be a good fit for Emerging Markets and would request that The BIS consider the proposal above regarding the discretionary use of the current Standardised Approach, as the complexities on implementation and operational capability will be significant to these markets with regard to the proposed Revised Standardised Approach.

## Section 1: Overall revision to the market risk framework

### *1.1 Trading Book / Banking Book boundary*

We welcome the approach proposed with respect to trading book / banking book revised boundary.

The proposed rules, whilst very good for developed markets, might have a disproportionally negative impact on the development of active secondary markets in some emerging and frontier markets, if they are applied without taking into account the local conditions. Some flexibility is required on developing markets as they do evolve through time, otherwise the rules might push a lot of developing trading activities into the banking book. In this regard we would propose that clarity is provided to the extent that banks be allowed to deviate from the presumptive list per their internal policies and then seek regulatory approval rather than seeking approval *a priori.* We would also motivate that the presumptive list be updated as and when conditions change.

There is also a high level concern over the classification approach and its effect on the portfolio structure and management of portfolios that are close to the boundary. The impact of this approach still needs to be carefully assessed in terms of whether historical portfolios would need to be reclassified and managed appropriately.

The capitalisation of default risk in trading portfolios are going to be aligned to banking book standards (at a point) in order to minimise regulatory arbitrage of the boundary. We are supportive of this (for example, the current standardised CVA calculation for regulatory capital requirements explicitly utilises external credit ratings over internal ratings from banks with AIRB approval).

More clarity is required in terms of:

- The treatment of structured notes businesses and specifically, that if client liabilities are hedged by on-balance sheet assets including equity and fund investments, they would qualify for trading book treatment across all asset classes.
- Liquid Asset & Surplus Liquid Asset portfolios
- Whether the new boundary rules would allow fair valued instruments and especially potentially liabilities in the banking book to be classified as banking book given their use to manage liquidity and interest rate risk as part of ALM activities. The use test should permit so given the low turnover that may occur in the banking portfolio.

We look forward to the upcoming proposals regarding the capitalisation of interest rate risk and credit spread risk in the banking book and further, how this relates to the TB/BB boundary. The potential impact of this (outside of the FRTB) needs to be carefully examined.

***1.2 Treatment of credit***

***1.2.1 Non-securitization credit exposures***

We welcome the idea to stop double counting the volatility of credit spreads in VaR and IRC, however the current proposal falls short by not providing a methodology for this. The text assumes a liquid equity market always exists to calibrate correlations. It is not always the case on Emerging Markets and the text is silent on this point.

A concern arises in terms of the requirement to risk-weight domestic currency sovereign bonds in local currency. Some local regulators have yet to progress their regulations requiring the need to account for this in terms of Basel 2.

***1.2.2 Securitisation exposures***

No comment

***1.2.3 CVA***

The document does not address the issue with double counting the CVA charge in internal model as well as the CVA standalone charge. However, we note that possible reform of the CVA capital treatment is underway and we look forward to those proposals.

***1.3 Factoring in market liquidity***

The approach of applying liquidity risk horizons for each relevant risk factor and sub-category would in all probability fail the "use" test and the pre-defined liquidity horizon table seems highly punitive at first glance.  We feel that the approach also fails to consider cross risk factor impacts (e.g.: cross gamma, contingent risk factor dependencies, which exist also outside structured products), and is simplistic from this perspective.

We support the industry proposal to the TBG to utilise a scalar approach rather than static horizons. The multiplier approach would allow banks to calculate the ES measure on the basis of their internal risk management horizon requirements and then scale the result to achieve the regulators requirements in terms of liquidity horizon. An approach that links the regulatory capital result to banks' internal risk management is preferable.

Additionally we would like to raise the following issues:

- The proposed framework on liquidity fails to consider the market depth vs. position size dimension. Oversized positions on so-called liquid markets are much less penalized than small positions on so-called illiquid markets.
- The proposed liquidity horizons per asset class may need to be revisited based on the split between developed market vs. emerging market dynamics. Also, having FX being deemed less liquid than equities seems anomalous.
- Making liquidity a function of credit will lead to cliff effects at the trading book/banking book boundary. Emerging market bonds seem to be abnormally penalized, especially if they are issued in local currency and potentially liquid up to a threshold.

***1.4 Choice of market risk metric and calibration to stress conditions***

- Moving to expected shortfall

We welcome this change replacing the current triple counting regime of VaR + SVaR+ IRC. ES is a better tool to capture tail risk which is most appropriate in the emerging markets where there's a prolonged period of stable prices followed by big jumps.

This also aligns with the FRTB intention/approach of increased risk sensitivity of regulatory capital requirements to portfolio exposures.

- Calibration to stressed conditions

We support the single calibration to a stressed period (i.e. the movement away from current normal VaR + stressed VaR approach) is strongly supported.

***1.5 Treatment of hedging and diversification***

We have some concerns with the proposed rules in that it could drive wrong behaviours. There is very little economic rationale for disallowing real diversification benefit.

Very little diversification benefit is given across risk factors, as per the proposed formula. This disincentivises a modelled approach.

***1.6 Relationship between the standardized and internal model-based approaches***

We do not support the idea of a floor between standardized and modelled approach, because:

- The hybrid nature of a floor approach makes it very difficult/ impractical to manage.
- It removes the incentive in going for a modelled approach. There is a concern that banks will not fund risk systems and infrastructure required under the modelling approach, if there is little or no incentive to do so.

**Section 2: Revised models-based approach**

***2.1 Overall approach to internal model-based measurement***

*2.1.1 Granuralisation of Regulatory Approach / IMA at desk level*

Regulatory capital requirements will now be determined at a pre-defined desk levels with the ability for the regulator/bank to capitalise business segments discretely. This also allows for IMA to be switched off at a desk level should there be concern with a given business.

Our current preference would be for IMA approval to be given at a risk factor or major business unit level as the relative reward of reducing (overall banking) systemic risk is diminished through managing regulatory capital requirements for desks or business levels at decreasing granularity.

Our current perspective is the level of detail/reporting and management for regulatory capital requirements at individual business levels may not be suited towards achieving reduced system risk at the expense of increased operational requirements.

***2.2 Identification of eligible trading desks***

***2.2.1 Definition***

No comment

***2.2.2 Model approval process***

*P&L attribution and back-testing*

We note that under the current model approval criteria, it would be possible to have the same product approved at one desk and not another.

*Model Independent Assessment Tool for Desk*

We support the intention of the model independent assessment tool, namely to capture the possible occurrence of market stress scenarios that have not occurred in the past. However, a leverage ratio provides almost no information about a desks exposure to market risk. A measure that captures the quantum of both directional and basis risks is far better suited to the intention of the measure and would yield more correct and intuitive results than a leverage ratio. Additionally, the stress testing approach could be strengthened by linking it to banks' ICAAP processes already in place.

***2.2.3 The identification of modellable risk factors***

We note that a rigid application of the criteria in determining modellable vs. non-modellable risk factors can result in high capital volatility for a particular desk.

## Section 3: Revised standardised approach

**3.1 Objectives**

No comment

**3.2 *General features of the revised standardized approach***

The calculation of the SA is now a mandatory requirement and must be run in parallel with the IMA. The calculation of the standardized approach, on top of IMA, will represent a complex and operationally intensive process (especially for emerging markets and smaller banks) which will need systems with significant data dependencies. In this regard we repeat our earlier request that dispensation be provided for smaller banks, at the discretion of their national supervisor, to use the current Standardised Approach.

The use of the standardized approach as a floor or surcharge is still under review by the BIS. We would not support the application of the Revised Standardised Approach as a floor to the IMA.

The Revised Standardised Approach proposal requires banks to implement an entirely new process to meet the data requirements, as well as the new model. This new data requirements would necessarily be unique from all other uses in the bank and would not be validated in terms of either the use test or the Finance department. This creates a high degree of operational risk and is an additional burden to the IT development requirements to build the model. For example, testing indicates that the incremental increase in calculation steps for the Revised Standardised Approach over the current Standardised Approach is an additional 424 steps.

We support the use of a fuller risk factor approach that makes use of data (such as risk sensitivities like PV01's) and processes already well vested in banks and validated by the use test, the Finance department, as well as the internal and external audit functions.

***3.3 Calibration of the revised approach***

No comment

**3.4 *Proposed treatments by asset class:***

The approach to determining interest rate risk should allow for the use of zero sensitivity Pv01 as a tool to replace the assignment of percentages such as 80% and 20% used in the example. This will make it a lot easier to compute especially for large swap portfolio's as an example.

**Section 4: Disclosure requirements**

We are not supportive of the requirement to publicly disclose desk structures. Also, we would request clarity on whether the CVA desk would be seen as a standalone desk.

**Section 5: Impact assessment**

Appropriate time should be given to allow for computations given the significant change being considered with guidance to be provided ensuring common understanding of methodology for determining the standardized approach. In this regard, please see our proposals in the introduction.

**Annexure 1: Revised market risk framework**

We have made reference to issues / recommendations under the various paragraphs as follows:

***Para 32***: Would the frequency not be more than quarterly for all parties?

***Para 34***: This is welcomed but should be applied by all jurisdictions

***Para 180***: Please clarify frequency of ongoing validation

***Para 181***: Please reconsider 2005 as this would require increasing computations in years to come. Could allowance be granted to go back to this period but only compute when the period is deemed to be a tail risk scenario as opposed to computing for benign periods?

***Para 200***: Given that 2008/2009 was in some cases more extreme than 1987, could the 1987 be dropped?

***Para 203***: Could the requirements for internal validation apply to these ahead of review by internal auditors/external auditors

**Conclusion**

It may be appropriate to consider a parallel QIS specific process with emerging markets to ensure that adequate attention is given to the potential calibration nuances with the proposals. In this way an early intervention is possible and standards could be modified to take into account the absence of liquid markets, various developmental stages of economies and other unintended consequences.

We hope that our comments have added value to your deliberations.

Should you require any further information, please do not hesitate to contact me.

Kind regards

Gary Haylett

General Manager
Strategic Projects