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CHINA BANKING ASSOCIATION

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29 January 2014

Mr. Wayne Byres, Secretary General of the Basel Committee  
The Secretariat of the Basel Committee on Banking Supervision  
Bank for International Settlements  
CH-4002 Basel, Switzerland

Sent by email to: [baselcommittee@bis.org](mailto:baselcommittee@bis.org)

**Re: BCBS Second Consultative Document on Fundamental Review of the Trading Book: A Revised Market Risk Framework**

Dear Mr. Byres,

China Banking Association ("CBA") is a nationwide non-profit self-discipline organization of China's banking sector. CBA serves for the common interest of its members through the functions of self-discipline, rights protection, coordination and service so as to safeguard market order of the banking sector, and promote the healthy and sustainable development of the industry. By November 2013, CBA has 354 members and 3 observers.

CBA appreciates the opportunity to comment on the Basel Committee on Banking Supervision Second Consultative Document: *Fundamental Review of the Trading Book: A Revised Market Risk Framework* dated October 2013.

The consultative document greatly improves the risk sensitivity of trading book capital measurement, and consequently strengthens the resilience of the whole banking sector. However, taking into account its far-reaching impacts, the framework may exert great influence on banks' internal risk management, measurement and the IT system.

To ensure the framework taking care of the interests of banks in different sizes and from various jurisdictions, the following comments were made for your reference. We hope

you find our comments helpful. And we sincerely appreciate the great endeavor you have made in global financial supervisory reforms.

Yours faithfully,

A handwritten signature in black ink, reading "Yang Zaiping". The signature is written in a cursive, flowing style with some ink bleed-through from the reverse side of the page.

Yang Zaiping  
Executive Vice President  
China Banking Association



## **General comments**

**I. We'd like to suggest the Committee to be fully aware of the costs that the new requirements of the consultative documents (CD) may have on small- and medium-sized banks.** The newly developed capital measurement methods, in particular the Standardized Approach, may bring heavy burdens for small- and medium-sized banks, especially banks from emerging economies where economic development stage, market structure, and trading activities are much different from developed countries.

**II. We suggest the Committee to rethink the inter-linkage between IMA and SA.** If SA is to be used as a floor to IMA, it should be carefully calibrated so as to provide banks reasonable incentives to adopt advanced approaches.

**III. We hope that the Committee could specify whether the proposed calculation, such as definition of trading desk, the eligibility assessment of the appliance of model-based approach and stress period calibration are applicable for banking book positions. In addition, guidance on hedging and diversification between banking book and trading book positions should be further clarified under this new framework.** The FX and commodity positions in the trading book and the banking book are both covered within the current Basel III market risk capital calculation. Whereas in the consultative document, all the risk metrics are designed for trading book positions, and those for the FX and commodity positions in banking book are not specified.

**IV. Given the significant changes introduced in the revised market risk framework, we suggest that more phase-in time should be given for banks to revise their internal risk management policies, processes and systems.**

## **Specific comments**

**I. The trading book / banking book boundary and risk management policies for covered positions**

Page9, table1: Guidance on appropriate contents of the trading book

Based on the current book boundary, financial instruments, including options, which act as the hedging instruments for banking book items, as long as they fulfill the hedging effectiveness tests, they could be regarded as banking book items. When calculating market risk capital charge, according to the book coverage requirement of risk classes, FX and commodity options in the banking book should calculate their market risk capital whereas interest rate and equity options in banking book should not.



In this consultative document, however, we are wondering whether all options should be classified as trading book item, and whether all options need to calculate market risk capital. If it is true, from book management point of view, it will lead to different management target for banking book hedged items and their hedging instruments.

Moreover, it is not so reasonable or feasible that a bank should adopt trading book management method to manage the option positions which are held for hedging banking book risk, because, for instance, it is difficult to apply trading book management standards such as stop-loss limit on the banking book options. From the capital calculation point of view, whether an option should calculate the market risk should align with the hedged items.

Page 49, Paragraph 12: As it is possible there will be jurisdictional variance in terms of what should be presumed to be included in the trading or banking book, each supervisor could provide specific guidance on this subject. Banks will be expected to assign instruments to the appropriate boundary designation based on this guidance. If a bank believes that they have to deviate from the presumption list for a certain instrument, the bank must submit a request to its supervisor and receive explicit approval. In cases where this approval is not given by the supervisor, the instrument must be switched to the trading book.

We suggest the term “instrument” be clarified. For example, if a bank holds one IRS to hedge banking book’s interest rate risk, does the bank still need to classify this IRS to the trading book?

Page 50, Paragraph 18: notes that, covered instruments must be subject to clearly defined policies and procedures, approved by senior management, that are aimed at ensuring active risk management. The application of the policies and procedures must be thoroughly documented, such as the activities the bank considers to be trading or hedging of covered instruments and therefore constitutes elements of the trading book for regulatory capital purposes, and so on.

We think that there is usually some kind of activities which need not only ex-ante identification, but also ex-post confirmation or overturn. We think it is better for the Committee to make a more comprehensive list for bank to comply with in case of the above situations. We wish that the rule for boundaries between the trading and banking book can be more specific, practical and consistent with other regulatory rules like IAS and also bank’s internal management procedures. Here follows some more questions we have.

- 1) The revised method may cause two different ways to calculate one risk type. Is that permitted?
- 2) Some options deals are for hedging or managing risks of loan, deposit or other banking book assets or liabilities, so it should be allowed to have banking book. We suggest changing the classification standards for options.

- 3) Either evident-based or valuation-based method will cause a fundamental change in risk management infrastructure. The boundary between trading and banking book will be much harder to clarify and may also lead regulatory arbitrage. What's more, if strictly applied, there may not be qualified desk for capital charge; a trader may have to trade in trading and banking book. Is that permitted?
- 4) Either the evident-based or valuation-based method denies the intention and effect of risk diversification or hedging strategy, since deals may not qualify evident requirements. How to avoid that?
- 5) There will be a huge gap between the capital regulatory framework and accounting framework. The new IAS rule is more aligned to Basel II since both of them have two classifications. Inconsistence between these two standards may make internal management processes more difficult. How to solve that?

P51, Paragraph 19, (d): Reports on the assessment of market liquidity

The Document asks that all the banks must prepare and evaluate "reports on the assessment of market liquidity" for all trading desks. We do believe it is necessary to take serious consideration on market liquidity, but so far there is no standard method for us to value the liquidity for "all trading desks". Different (even the same) products combined with different strategies have distinguished liquidity demands. If the document can provide some certain and exercisable methodology, we would be more than happy to do this in the coming future.

6. The Document requires banks must have enough evidence to support the assignment of an instrument to the trading book. It is a great change for the definition of the trading book and may transform the method on book selection. But clearer information on the "evidence" is still necessary. For some instruments, such as bond, it might have similar activities in trading book as well as AFS(available for sale) booking. So, we believe it's important to have specific guidance on how to choose necessary evidence for further assignments.

## **II. Revised models-based approach**

P25, Paragraph 4: The capital charge for eligible trading desks would be the aggregated capital charge for modellable risk factors plus the sum of the individual capital requirements for non-modellable risk factors plus the IDR charge.

Over-prudent measurement may cost accuracy to some extent and make management less persuasive. So we think it is a good move to eliminate IRC to avoid double counting.

Page 85, Paragraph 180 (h): Any significant changes to an approved model must be approved by the supervisor prior to being implemented.



It would be better if the Committee would define “significant changes to an approved model”. Will the changes to market curves (including interest rate and volatility curves) or parameters be classified as significant changes? Do the banks need to get approvals from their regulators before changing to market curves or parameters are implemented?

P86, Paragraph 181 (d) :The expected shortfall measure must be calibrated to a period of stress.

- 1) We suggest the Committee allow local regulators to use discretion to provide guidance on the stressed period calibration for the financial institutions within jurisdiction. Firstly, if a bank is able to fulfill the market data requirement, we suggest the Committee keep “direct” calibration as an option; secondly, local regulators propose observation horizon options based on the business models and the portfolio risk profiles of local financial institutions to enable banks to perform calibration tests within those options to select appropriate stress period.
- 2) If the “indirect” calibration method is adopted, please specify the reduced risk factor identification and the test of the 75% explanation power.
- 3) Please specify the implementation level of stress period calibration. We are wondering whether it should be applied at the entity level including the trading book and the banking book for market risk capital calculation, or trading book level, or trading desk level.
- 4) Please specify the frequency for stress period calibration.

Page 87, Paragraph 181(k) as set out in point (c), an instantaneous shock equivalent to an n-business day movement in risk factors is to be used. n is calculated using the following conditions

- 1) As FX and precious metal (such as gold, which belongs to FX) are very liquid in the market, we would like to suggest that the liquidity horizon of FX and precious metal be set to 10 days instead of 20 days.
- 2) The table in page 87 is not consistent with Table 2 in page 16. In page 87, only Interest Rate Volatility is specified at “ATM (at the money)” while all volatilities in Table 2 are specified as ATM volatility. In addition, we believe that it would be difficult for most banks to adopt different liquidity horizons for volatilities of different moneyiness (ATM and non-ATM). Hence, we would like to suggest that (a) to specify ATM volatility as a board category (that is, across all risk factor types), (b) to define ATM volatility as  $\delta = 0.5$ , and (c) to adopt the same liquidity horizon for volatilities across all moneyiness.
- 3) We believe it is difficult for most banks to adopt different liquidity horizons across different maturities and moneyiness within each market curve, as most curves comprise several maturities and / or moneyiness. Hence, we would like to suggest that as the same liquidity horizon be used for all risk factors within each market curve (including interest rate curves, volatility curves, etc).



Page 89, Paragraph 183: The process for determining the eligibility of trading activities for the internal models-based approach is based on a four-stage approach

We suggest periodic reports on the eligibility evaluation of models-based approach adopted at trading desk level be submitted to the regulators and the regulators are able to annually adjust the coverage of the models-based approach. The merit is that the consistency of the capital measure among desks is assured for a certain period and at the same time the stress imposed on banks to frequently perform the models-based approach eligibility assessment and the impact on the daily risk management are reduced.

For out-of-scope desks that temporarily fail to meet the evaluation requirement and use SA to calculate capital, as well as the non-modellable risk factors, please specify the standards and the process of “moving-back” to the IMA scope.

Many banks have built an internal management frame work base on VaR, including economic capital management, internal risk cost charges and trading limits (including stop loss limit). These procedures are advanced model application and can help banks to actively manage risk. But research or practice based on ES model is rare. If apply the internal model revision in such a short time, there will be gap between capital charge and other management tools, then capital charge may end up to a figure only.

Page 92, Paragraph 185(c): For exchange rates (which may include gold), the risk measurement system should incorporate risk factors corresponding to the individual foreign currencies in which the bank's positions are denominated.

Given that gold is classified as commodity risk under the revised Standardized Approach, would gold be also classified as commodity risk under the revised IMA approach?

Page 93, Paragraph 186 (b) and (c): Default risk must be measured using a VaR model. Banks must use a two-factor default simulation model with default correlations based on listed equity prices. Correlations must be based on a period of stress (as defined in paragraph 181(d)), estimated over a 10-year time horizon and be based on a [one]-year liquidity horizon. The VaR calculation must be done weekly and be based on a one-year time horizon at a one-tail, 99.9th percentile confidence level

(c) All positions subject to the market risk framework, with the exception of those positions subject to standardised charges or whose valuations depend solely on commodity prices or foreign exchange rates are subject to the default risk model. Therefore, sovereign exposures (including those denominated in the sovereign's domestic currency), equity positions and defaulted debt positions must be included in the model.

1) It was mentioned that “with the exception of those positions subject to standardised charges or whose valuations depend solely on commodity prices or foreign exchange



rates are subject to the default risk model". However, FX and commodity options are also exposed to interest rate risk, although interest rate risk is not significant for these option products. Hence, would such options be excluded from default risk assessment?

2) Is there any restriction on the type of "two-factor default simulation model"? Can the Committee provide guidance on how such a model can be implemented?

3) What types of factors can be used in the "two-factor default simulation model"? Can equity indices be used?

4) If the bank has government and corporate bond exposures in various countries, is the bank required to segment the exposures by individual country and adopt a different 2-factor default simulation model for each country (and perform joint simulation so as to capture correlations across countries), or the bank is required to use the same 2-factor default simulation model for all exposures? If the same 2-factor default simulation model must be used, wouldn't it be difficult for the bank backtesting / validate the model?

5) Can the bank adopt a default simulation model with more than 2 factors?

6) If the objective of the simulation model is to simulate defaults, why would there be a need to include "defaulted debt positions"? If defaulted exposures are included, how should the "default event" of such exposures be simulated?

Page 93, Paragraph 186 (b) , (c) and (f) Default risk must be measured for each obligor  
• PDs implied from market prices are not acceptable unless they are corrected to obtain an objective probability of default.

• PDs are subject to a floor of 0.03%.

1) For banks adopting the IRB Approaches for credit risk, can the PDs estimated from the internal credit risk models be used (assuming that such PDs have been validated)?

2) Can the Committee provide guidance on how PDs implied from market prices should be corrected to obtain objective probabilities of default?

Page 94, Paragraph 186 (l) As part of this default risk model, the bank must calculate, for each and every position subjected to the model, an incremental loss amount that the bank would incur in the event that the obligor of the position defaults

1) Can the Committee provide guidance on the "incremental loss amount" which should be computed?

2) What is the objective of computing the "incremental loss amount"? In particular, does this loss amount feature in the IDR capital charge?

Page 94, Paragraph 186 (m) these loss estimates must reflect the economic cycle; for example, the model must incorporate the dependence of the recovery on the systemic risk factors.



- 1) Can the (systemic) risk factors used for driving recovery rates different from the risk factors used in the “2-factor default simulation model”? If yes, must the defaults and recovery rates be jointly simulated, or can they be independently simulated?
- 2) Is there any restriction on the model used for simulating recovery rates? For instance, must such a model be also restricted to only 2-factor models?

*Page 94, Paragraph 186 (o) To avoid double counting of the risk from mark-to-market loss and the risk of loss from default, the model may assess default risk from the perspective of the incremental loss from default in excess of the mark-to-market losses already taken at the time of default.*

If exposures included in the IDR model are non-defaulted exposures, what does it mean by “mark-to-market losses already taken at the time of default”? Does that mean such losses are 0, or does this mean the “expected losses” that the bank has already set aside for the non-defaulted exposures?

*Page 94, Paragraph 186 (q) Firms should strive to develop relevant internal modelling benchmarks to assess the overall accuracy of their IDR models.*

If the internal modeling benchmark is developed by the independent model validation team within the bank, is the model subject to further “independent validation” or “independent review”? If yes, would the bank be required to establish a team that is independent from the “independent model validation team” so as to review the internal modeling benchmark?

*Page 94, Paragraph 186 (r) Due to the unique relationship between credit spread and default risk, banks must seek approval for each desk with exposure to these risks, both for credit spread risk and default risk. Desks which do not receive approval will be deemed ineligible for internal modelling standards and be subject to the standardised capital framework.*

- 1) Does the above requirement apply to equity trading desk / portfolio? If not, can the bank still apply for internal model approval for the equity risk in its equity trading desk, leaving the default risk to be assessed under the SA?
- 2) Besides credit spread risk and default risk, bond portfolios are also subject to interest rate risk. For these portfolios, would the bank be eligible for adopting the internal models approach for interest rate risk, leaving credit spread risk and default risk to be assessed under the SA?

*Page 94 Paragraph 186(r): Due to the unique relationship between credit spread and default risk, banks must seek approval for each desk with exposure to these risks, both for credit spread risk and default risk. Desks which do not receive approval will be deemed ineligible for internal modeling standards and be subject to the standardized capital framework.*

For banks using individual equity prices in their internal VaR model, is it still necessary calculate IDR as for equity exposures?

Page 95, Paragraph 189: The aggregate capital charge for modellable risk factors (IMCC) is based on the weighted average of the constrained and unconstrained expected shortfall charges.

$CA = \max \{ IMCC_{t-1} + SE_{St-1}, mc(IMCC_{avg} + SE_{Savg}) \}$

The plus will range from 0 to 1 based on the outcome of the backtesting of the bank's daily VaR at the 99th percentile based on current observations on the full set of risk factors (VaRFC).

We would like to suggest that the capital be aggregated at the desk level instead of risk factor level.

### **III. Revised standardised approach**

Page 56, Paragraph 47: The standardised approach must be calculated by all banks and reported to supervisors at least monthly.

We would like to suggest that banks adopting the IMA are not required to calculate the market risk regulatory capital based on the Standardised Approach.

P56, Paragraph 50 notes that, the revised standardized approach sets out principles for decomposing instruments by type, followed by a detailed decomposition of common instruments. Where a detailed decomposition of an instrument is not provided, the principles should be applied, in a prudent and consistent manner. If a bank is unable to decompose a position they should consult with their supervisors, who will require a prudent percentage of the notional or market value.

We agree that the standardized approach should be more sensitive, but this proposal has no explicit methodology for the position decomposition which will make the bank confused, and also difficult to avoid the regulatory arbitrage thus coming.

Page 63, Paragraph 91 -110 sets out the detail steps that the bank should follow to calculate the capital charge for basic asset classes , specially point out the positions which divide into the general interest rate risk (GIRR) class and the credit spread risk(CSR) class should use discount cash flows using the appropriate yield curve.

The standard approach is much complicated compared with now, but still not sensitive to risk. Some measurement like PVBP on each key bucket have similar concept but is more applicable since it can be used as a limit to front desk, which works better in management practice.



Page 72, Paragraph 126: Where the developed markets are defined as: North America, the euro area, the non-euro area western European countries (the United Kingdom, Norway, Sweden, Denmark, and Switzerland), Japan, and Oceania (Australia and New Zealand).

Given the Hong Kong equity market being well-developed, we would like to suggest Hong Kong be concluded to the list of developed markets.

#### **IV Factoring in market liquidity**

Page 14 : The Committee has agreed to the definition of a liquidity horizon as being: "the time required to execute transactions that extinguish an exposure to a risk factor, without moving the price of the hedging instruments, in stressed market conditions" . This definition implies that liquidity horizons will be assigned to risk factors, rather than to instruments.

We suggest that actual implementation of the varying liquidity horizons need a more specific rule and a more specific guidelines, especially in the internal models approach and the standardized approach. The liquidity horizon stated is too prudent to be accurate for some products, like FX, money market.