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**CONFIDENTIAL**

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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Sent by email to: baselcommittee@bis.org

Dear Sirs/Madam,

**Fundamental review of the trading book: A revised market risk framework**

This letter contains the response of Daiwa Securities Group Inc. ("Daiwa") to the Consultative Document: "Fundamental review of the trading book: A revised market risk framework" ("FRTB") issued by the Basel Committee on Banking Supervision ("BCBS") in October 2013. Daiwa welcomes the opportunity to comment on the FRTB for which public comment was sought.

We understand that the FRTB will be followed up in the coming months by the results from the planned Quantitative Impact Study ("QIS"). Daiwa very much hope to continue this productive dialogue and are committed to support the BCBS efforts of improving the FRTB proposals.

The following comments are provided for the BCBS consideration in response to the particular proposals of the FRTB.

<u>Please be advised that we would like the BCBS to kindly treat this letter as confidential.</u>

Yours sincerely,

Tsutomu Kobayashi
Head of Risk Management Dept.

**Comment 1.**
**Model-independent risk assessment tool for desks: inequality formula**

Daiwa understands that model-independent risk assessment tool for desks is subject to further refinement upon gathering information in the forthcoming QIS and would contribute to reducing excessive reliance on market risk models that rely entirely on historical price fluctuations to determine capital requirements.

Whilst it is quite intuitive that a desk would not be eligible for the internal model-based approach if the calculated amount of the numerator (Capital) is too small compared to the denominator (Exposure Measure), a contradictory definition is given in paragraph 183(d)(iii) in Annex 1 where it says if "inequality is breached then the model-based method may not be used and the desk must use the standardised approach."

$$\frac{Capital}{Exposure\ Measure} < Threshold$$

We believe it would make more sense to replace the phrase “inequality is breached” with “inequality is satisfied” to avoid any inadvertent effect.

**Comment 2.**
**Model-independent risk assessment tool for desks: treatment of IDR**

In addition to the above mentioned point on model-independent risk assessment tool for desks, the definition of Capital in paragraph 183(d)(i) in Annex 1 and the example of the "Trading desk risk disclosure report" in Annex 2 are inconsistent. The former defines Capital as "the desk-level Expected Shortfall (ES) plus the sum of capital requirements emerging from the stress scenario add-ons under the non-modellable risk factors framework" whereas the latter includes the IDR charge in its calculation of model-independent assessment. For instance, the Ratio of model-independent assessment for “Emerging market equities” picked out below includes the IDR charge in the Total IMA.

| | | | | | | | | | Risk Type | | Model-Independent Assessment | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Desk | ES (2) | NMR (3) | IDR (4) | Total IMA | SA w/o DR charge | SA DR charge(5) | Total SA | IMA/SA | Risk Factor | ES | Exposure | Ratio |
| Emerging market equities | 28 | 3 | 8 | 39 | 35 | 9 | 44 | 89% | | | 423 | 9.2% |

ES [28] + NMR [3] + IDR [8] = Total IMA [39]
Total IMA [39] / Exposure [423] = Ratio [9.2%]

To make model-independent assessment more independent from internal models, we are of the view that the IDR charge should not be included in the Total IMA when calculating the Ratio of model-independent assessment. Therefore, further clarification is expected on this point upon analysing the QIS results.

**Comment 3.**
**Revised standardised approach: decomposition of instruments**

Daiwa recognises the BCBS desire to strengthen the relationship between the revised

model-based approach and revised standardised approach. The standardised capital requirements for all institutions would be beneficial as a uniform benchmark. However, it is stated in the second paragraph in Section 3.2 that “supervisors will have discretion to impose prudent percentage of either the market value or the notional of the position” if institutions are not able to “decompose all instruments for the purpose of the standardised approach”.

Whilst we support three objectives of the standardised approach set out by the BCBS, we believe that allowing supervisory discretion would result in variations in the standardised capital calculation across institutions and jurisdictions, especially for complex and exotic products. Therefore, in order to facilitate transparent, consistent and comparable reporting of market risk across institutions and jurisdictions, supervisory discretion should be replaced by a consistent treatment across institutions and jurisdictions.

**Comment 4.**
**Revised standardised approach: Indices and baskets**

Two options are given in paragraph 58 to decompose indices and backets into notional positions. However, we find the criteria to which it is being referred in the following phrase is not clear; “A single notional position in the index, which should be placed into the relevant bucket if all parts of the index meet the criteria to go into a single bucket.” Therefore, we believe the criteria should be explicitly given before the finalisation takes place.

**Comment 5.**
**Revised standardised approach: credit spread risk (securitizations)**

Daiwa supports the BCBS proposal that “capital charges for securitisation positions in the trading book – including correlation trading activities – will be based on the revised standardised approach.” However, the table given in paragraph 122 in Annex 1 recognises more diversification benefit when there is more than 80% overlap in notional terms (e.g., 80% for “Cash flows have the same sign” and 40% for “Cash flows have different signs”. Therefore, we believe the heading should be inverted.

| | Same underlying names (more than 80% overlap in notional terms) | Different underlying names (less than 80% overlap in notional terms) |
|---|---|---|
| Cash flows have the same sign | 80% | 100% |
| Cash flows have different signs | 40% | 0% |
| Residual bucket – Cash flows have the same sign | 100% | |
| Residual bucket – Cash flows have different signs | 0% | |

**Comment 6.**
**Revised standardised approach: default risk (non-securitisations)**

Daiwa understands that the BCBS is making a great effort in incorporating default risk component into the trading book framework. However, we believe the procedure set out in Annex 1 for the default risk (non-securitisations) in the revised standardised approach is in need of further elaboration.

First, offsetting exposures to the same obligor set out in paragraph 148 in Annex 1 should not be carried out before summing up the loss risk-weighted positions for long positions in paragraph 149 in Annex 1 and the loss risk-weighted positions for short positions in paragraph 150 in Annex 1. It would fit better if it's included in Paragraph 154 in Annex 1.

Second, overall capital charge for each credit quality category in paragraph 154 will not be calculable if the summation in paragraphs 149 and 150 in Annex 1 across credit quality categories is done beforehand. Therefore, we think this procedure needs reconsideration.

Lastly, it would give us an insight to the BCBS intentions if the definitions for ambiguous phrases are provided; i.e, "LGD-weighted long positions", "LGD-weighted short positions", "credit quality subcategory", "asset class category". Also, our understanding of the notions of *Notional* and *MtMLoss* are; (i) *Notional* will be the market value for debt instruments as well as for equity instruments; (ii) *MtMLoss* will be the difference between the booking value and the market value. We believe some kind of a floor should be given to JTD in paragraph 147 so as not to allow any negative values. We would appreciate any advice on these points if our understanding is, by any chance, not in line with the BCBS view.

**Comment 7.**
**Revised standardised approach: options non-delta risk**

Daiwa acknowledges the "scenario matrix approach" will be used in capturing options non-delta risk in the revised standardised approach. Although we are aware that we should refer to the risk weight of the underlying as defined in paragraph 167 in Annex 1 in order to calculate the magnitude of the assumed shift in the underlying price or rate, we recognise the need of further clarification in this area. In particular;

- The assumed shift in the equity underlying may bring about a tremendous effect on equity options portfolio should the risk weights defined in paragraph 127 in Annex 1 be applied without any relaxation;
- There is no such definition as the risk weight for currency options;
- It is not clearly defined whether absolute shift or relative shift should be applied to the underlying except for interest rates;
- For interest rates, it is not clear whether the parallel shift or the grid shift is expected.

Furthermore, the assumed shift in the volatility needs further guidance;

- It is not clearly defined whether absolute shift or relative shift should be applied to the volatility;
- It is not clear whether the parallel shift or the grid shift in the volatility surface is expected;
- It is not clear how the signs of the vega are measured.

**Comment 8.**
**Introduction of the FRTB**

Daiwa would like the BCBS to allow sufficient time between finalisation and introduction of

these proposals in the FRTB for institutions to prepare for the investments in infrastructure and human resources, which are likely to ensue upon the implementation of new regulations, in a timely manner.