

Basel Committee on Banking Supervision

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Reference BR2097

Subject: NVB reaction to BCBS265 on the Fundamental Review of the trading book – 2nd consultative document

Dear Sir, Madam,

On behalf of the Dutch Banking Association¹ (NVB) I would like to thank you for giving us the opportunity to react to BCBS 265 on the Fundamental Review of the trading book.

The NVB welcomes the second consultation on the Fundamental Review of the trading book. The second set of proposals contains a number of significant improvements vis-à-vis the existing legislation as well as the first version of the consultation, in particular:

- The somewhat strange addition of a Stressed VaR on top of a 'normal' VaR is replaced by one stressed figure.
- The Expected Shortfall figure will use more tail information and is a valuable addition to the framework.
- The standardised approach will recognise hedging and offsetting to a greater extent, making it more risk sensitive.
- The revised boundary between the Trading book and Banking book will harmonise the implementation of the boundary across jurisdictions.
- The way diversification between assets classes is limited in the IMA approach is less complicated compared to the previous proposal.

Although the NVB welcomes these improvements, a number of concerns and questions remain. The most important ones are:

- It is unclear why – given the fundamental changes that are being proposed – so much pressure is being put on the speedy implementation of the new system, especially as Basel 2.5 already increased the capital requirements for trading book positions to more appropriate levels. In our view, a fundamental review calls for a thorough and in-depth discussion, e.g. via consultation papers and Quantitative Impact Studies. Longer time horizons would be beneficial in both areas.
- The proposed standardised approach is too complex and difficult to implement due to the amount of data required. We suggest the Basel Committee consider a framework that makes use of existing risk measures, such as the Greeks.

¹ The Dutch Banking Association (NVB) is the representative voice of the Dutch banking community with over 90 member firms, large and small, domestic and international, carrying out business in the Dutch market and overseas. The NVB strives towards a strong, healthy and internationally competitive banking industry in the Netherlands, whilst working towards wider single market aims in Europe.

- In the context of the fundamental review of the trading book, it would be logical to incorporate CVA risk in the review of the market risk framework. This creates an opportunity to solve some of the weaknesses of the current CVA framework, such as only recognising credit spread hedges, but not the hedging of other elements that influence CVA such as interest rates.
- Regarding the calibration of the new trading book framework, the capital levels should be maintained at the level of Basel 2.5. Given the cumulative nature of the calculation method, the requirements will be sufficiently conservative. Moreover, the calibration should ensure that there is a capital incentive for banks to move from the revised SA to the revised IMA.
- The NVB supports the objective to include market liquidity in the capital framework. However, the proposed methodology has a number of fundamental drawbacks. Hedging relationships on desk level, for instance, will be broken. Additionally, the proposed horizons for FX and IR are very conservative for all well established and liquid markets.

In the annex, you will find more detailed feedback. For additional examples and counterproposals, please also refer to the response provided by ISDA, dated 19th January, which is also supported by the NVB. Should you have any questions or remarks, please feel free to contact me at your convenience.

Kind regards,



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Annex – specific remarks regarding the CP

Quantitative Impact Study

- The NVB supports the BCBS undertaking a Quantitative Impact Study (QIS). This exercise will be crucial in understanding the exact impact of the new market risk capital requirements on banks' risk management practices and their daily business. Sufficient time should be reserved for this exercise in order to ensure understanding about the impact of the proposed framework, as it constitutes a considerable change from the current framework. Furthermore, the QIS should be conducted on a step-by-step basis as much as possible. The NVB welcomes the confirmation from the Trading Book Group that a two-step approach will be taken, where the QIS that is applied on actual bank portfolios will be the second step.
- It should also be noted that many banks will still struggle to perform a full QIS on their actual portfolios, as it will not be possible to implement the new models in the short timespan that is proposed. Other regulatory projects² within the financial markets area should also be taken into consideration. In order to execute the QIS properly, banks will be required to implement substantial parallel infrastructures for the standardised approach and the internal model approach, which all sit next to the current regulatory calculations. For the internal model QIS, additional data gathering, statistical estimations, testing and validations will also be required. This is not manageable within the proposed timeframe. Banks will likely be forced to make a substantial amount of assumptions and shortcuts will have to be taken. As a result, the quality of the outcomes cannot be guaranteed. It is in the best interest of all stakeholders, including the regulators, to take enough time for a thorough investigation and not to risk drawing the wrong conclusions. This could lead to a sub-optimal framework.

The trading book/banking book boundary

- The NVB welcomes the revised proposal for the trading book/banking book boundary, which takes into account the intent to trade and provides more clarity about the assignment of instruments.
- In order to ensure a consistent interpretation and implementation across banks, additional guidance will be required.
- Regarding the allocation of products to books, it should be possible to assign the same instruments to both books, e.g. interest rate swaps that are used to hedge interest rate exposure in both trading- and banking books.
- Furthermore, the re-assignment of instruments will be substantial. In this context, the NVB supports an approach that is based on notification, not approval. This means that any assignment of instruments would first be implemented by a bank, followed by a notification to the competent authority. The notification requirement should be subject to a materiality threshold, in order to ensure a focus on material changes. Also, there should be a maximum allowed timeframe for competent authorities to respond to notifications.
- We understand that commodities, FX and other instruments may be subject to a market risk capital charge. The creation of virtual trading books with a virtual P&L should be restricted to those positions that are calculated using the IMA approach.
- Attention should be paid to instruments that are used to hedge banking book positions (such as hedge accounting and CVA risk). In this context, we would like to highlight the potential impact of prudent valuation. The changes made regarding prudent valuation can have an impact on the solvency position of a bank and may necessitate setting up new hedges. These hedges will probably require a special treatment in the trading book.

² Mifid, EMIR, Dodd Frank, AQR.

Treatment of credit

- For default risk, the NVB supports moving to a charge that doesn't include migration risk, as this will avoid double counting. However, a simpler method - that is consistent with the banking book - could be used. If the current proposal remains unchanged, more guidance will be required to ensure consistent interpretation across banks. For example, clarification is required about the definition of a 2-factor model and about the way equity correlations have to be translated to default correlations for that model, including how to apply them to sovereign exposures. For the same reasons of consistency, the NVB advocates using the IRB correlations, a one factor model, constant LGDs and a lower floor for sovereigns.

Approach to risk measurement

- Regarding the stressed calibration, the NVB recommends spanning the minimum observation horizon back to 2008, instead of 2005. The shocks observed in all of the risk factors during 2005-2008 are small compared to the levels observed during the crisis in 2008/2009. Also, a number of risk factors that are currently widely used (such as OIS and certain tenor basis spreads) did not exist in 2005.
- The current ratio of the full vs. reduced ES will be different compared to stressed periods, as basis risks were present in stressed markets which are not present now. Too much freedom in selecting reduced sets will result in variability between banks.
- If a bank can cover 95-100% of its risk factors during a stressed period, this bank should be allowed to directly estimate its stressed ES, without any scaling based on the current period.
- In case scaling will be applied, the NVB advocates calculating the stressed period on a weekly basis.

A comprehensive incorporation of the risk of market illiquidity

- In general, the NVB agrees to the principle of taking different liquidity horizons into account. However, it is unclear if the proposed method is the most suitable approach. Furthermore, some of the chosen liquidity horizons are penalising with reference to certain risk factors and sometimes appear to be inconsistent. This is particularly the case for FX and interest rates. The NVB proposes to change the liquidity horizon for FX- and interest rates to 10 days for all well established and liquid markets. This should be supported by observed market data during the latest and earlier crises. In our view, the Basel Committee is best positioned to specify objective and measurable criteria that define what constitutes established and liquid markets.
- The direct use of returns from different liquidity horizons in the historical method will break the link between the capital charge and the way risks are managed at desk level. It will also break the link between the capital charge and back testing.
- The use of different liquidity horizons may lead to illogical co-movements of risk factors, which might break hedges. Some examples of hedges that could be broken are: corporates hedged with sovereigns, small corporates hedged with large corporates and volatility positions hedged with spot positions.
- In order to preserve logical correlations, the NVB favours using a common liquidity horizon for the ES calculation, as well as imposing stress type add-ons or scaling factors for less liquid instruments/risk factors. Using a 10 day liquidity horizon would preserve meaningful correlations and doesn't require additional data gathering.

Treatment of hedging and diversification

- The NVB welcomes the proposal regarding hedging and diversification for the IMA approach. However, as was highlighted in the previous section, the use of different liquidity horizons could underestimate the observed correlations between closely correlated rates or assets within one risk factor category.

Relationship between internal models-based and standardised approaches

- The desk level SA results are unlikely to be comparable between institutions and might create incentives for banks to organise desks in a way that provides the best disclosure related outcomes, regardless of the question whether it is a sensible structure from a business and risk management perspective. This should be avoided.
- The NVB does not support using the SA as a floor or a surcharge, as this does not provide the right incentives for continuous model improvement. Also, the use of automatic surcharges should be avoided. Surcharges should be based on the individual circumstances at a bank and they should be set by the competent authority if circumstances so dictate.

Revised models approach: acceptance criteria and model performance.

- The NVB does not support the introduction of a model independent risk tool that will be used to assess the eligibility of a trading desk for the revised IMA. It is unclear how this new tool will achieve the objective of identifying desks with complex, potentially illiquid instruments that carry higher model risk. Such a tool would essentially be the same as introducing a non-risk sensitive floor to the IMA capital charge, which could cause desks with a low-risk profile not to be approved for the IMA approach or desks would be obliged to 'mis-hedge' their book to increase the internal capital requirement. The intent of the TBG to identify hidden risks without the use of a model is understood and valid, but there are other ways to ensure proper capitalisation.
- Due to the low relevance and meaning of statistical outliers on the individual desk level it is not clear if testing model performance on a desk level will produce sensible results. Failing a statistical outlier test should not result in an automatic obligation to move that desk to SA., as this would remove the incentive to improve the framework.
- More clarity should be given about the criteria that have to be fulfilled before a risk factor can be considered modelable. Will, for instance, rates or indices delivered by sources like MarkIT be accepted? Also, more clarity should be given about the level of granularity that is required in defining a 'risk factor' e.g. in case of debt instruments, is credit spread observable if there are traded quotes for corporate bonds in general, for a certain group of similar names or should there be a trade able price for every single issue?
- Furthermore the remarks on the allowed periods between observations suggest that these data don't need to be available on a daily basis, which is difficult to understand for a daily risk calculation. We would appreciate clarification on this.
- More clarity should also be given about the 75% criteria with regard to risk factors that explain the variation of ES. It is not clear how this would be measured.
- There should be more clarity about how the factors that are not modelled, but for which capital is calculated, are taken into account for back testing, especially for back testing against the actual P&L.

Revised Standardised approach

- The proposal for the revised SA is quite complex and simplification is desirable. For instance, there are other methods than the cash flow approach, that better match existing risk management practices. These practices are less demanding for banks to establish and maintain, but produce the same or better results. Hence, the NVB suggests considering a simpler framework that is designed more along the lines of a sensitivity based approach. Comparable elements as convexity can be factored into the risk weights as a function of maturity.
- Using the sensitivity approach also solves a number of problems regarding to the currently proposed cash flow method, for instance it does not ignore floating legs of products.
- Especially for interest positions, the possibilities for netting within product classes should be increased; a market maker in swaps that has an almost fully hedged portfolio would still be required to use a 10% aggregate risk weight.
- As indicated earlier, the NVB strongly advocates the use of the sensitivity approach instead of a cash flow approach. Should the Committee decide to adopt a cash flow approach, it should be substantially simplified. A concrete suggestion for simplification is using a limited number of

general curves to discount the cash flows, instead of using instrument specific spreads for discounting.

- Last but not least, there is a concern that the standardised approach could lead to a false sense of security. Broadening the categories will not lead to a full risk sensitivity of the standardized model. This could lead to wrong conclusions during benchmarking exercises. In cases where models failed in the past, it is unlikely that a standard model *will* capture such risks. For example, basis risks are not captured explicitly in the standard model and risk factors for complex products are not explicitly modelled. Also, it will lead to continuous questioning or criticizing of the standard model, the internal model or both. Time-consuming efforts to explain why standard figures and internally calculated figures do not align will probably be required.