ERSTE GROUP

Position Paper
Erste Group Bank AG

Fundamental Review of the Trading Book

BCBS Consultative Document from October 2013 (2nd Consultation)

Vienna, 15. January 2014

Please note that Erste Group Bank AG (EGB) does not want its comments to be published or disclosed.

EGB in general welcomes the possibility to comment on the published Consultative Document by BCBS regarding the `Fundamental review of the trading book: A revised market risk framework.´

General Remarks

1. Introduction

In principal all the proposed new requirements lead to a significantly increasing workload and massive investment in new IT-infrastructure in light of this huge effort one has to carefully challenge the benefits of the proposal:

Under the current risk architecture the Standardized Approach is used only as a fallback if certain risk exposures cannot be covered in the Internal Model. The currently proposed future architecture adds significant complexity through the introduction of Liquidity horizons, Expected Shortfall for capital charge calculations and Value-at-Risk calculation for back-testing purposes in addition to a more sophisticated Standardized Approach. How does it goes align with the generally stated aim of making regulation easier?

Furthermore the calculations that have to be carried out following the proposal would not be meaningful for internal steering, especially due to the proposed liquidity horizons which do not reflect the real market conditions. So the bank ends up in processing the new calculations and simultaneously running internal steering calculations. Pre-calculations for the new Standardized Approach also show that for certain trading desks the numbers calculated in the Standardized Approach are not in line with the numbers from the Internal Model. Therefore we propose that in case of back-testing outliers no switching between these two different methods should be envisaged. We rather propose to increase the internal model multiplier in case of too many outliers (same methodology as it is in place

now). This increase could happen also in cases of too many outliers on desk level, it would then increase the multiplier of the overall Value-at-Risk.

Risk calculation of products should be more product-oriented and accounting-based. We want to avoid different treatment of instruments in the Accounting Standards and the Trading Book Regulation.

The new regulatory framework will have a severe impact on the operating business model for banks, both through the significant increase in capital allocated to these businesses and the associated implementation and operational cost of the new framework. These costs may be felt most acutely in small to medium sized banks without the revenues to justify this significant increase in costs. In the light of the current proposals it is therefore very likely that medium sized banks have to further deleverage or even drop out of certain businesses entirely which will result in a reduction of competition leading both to an increase of the “too big to fail” problem and an increased cost to the general economy through reduced competition in the financial markets. Hence it also results in a strengthening of the biggest players within financial markets, which already seemed to be seen as highly disadvantageous to the stability of financial markets at all and the dependency of general governments to a small number of institutions for certain necessary businesses in particular.

An additional general point we want to highlight is the revision of the internal model based approach. With its shift to expected shortfall calibrated to a stressed period and taking into consideration different liquidity horizons will result in higher complexity and the fact that the financial crisis will be always the benchmark for any future scenarios which we deem questionable.

2. Banking book←→trading book boundary

- Within the latest proposal the committee published a revised boundary for the definition of the trading and banking book. Most of the criteria for the designation of instruments to either trading or banking book are still qualitative and it remains unclear from our understanding how this will impact the capital requirements.
- Additionally the current proposal mention that a capital charge for interest rate and credit spread risk in the banking book will be introduced. This aspect looks like a loose end as we understand the aim of the intended regulation is to address positions in the trading book. That raises the question if there are any new requirements for the banking book planned?

3. Standardized Model ←→ Internal Model

The proposal says that the capital requirement of the Standardized Model shall be used as a floor or an add-on. Here we see the need for more detailed information; especially the interdependence between the two models and concrete plans for future regulation would be necessary. It cannot be in the interest of the regulator that due to the high number of additional requirements and the related implementation costs medium-sized banks switch from the Internal Model to the less capital efficient Standardized Approach. This would foster a concentration of trading activities at bulge bracket firms and reinforce the too big to fail problem.

4. The Revised Standardized Approach

- It is clear that any revision of the current Standardized Approach being more risk sensitive will come along with some complexity. On the other hand, the current proposal on RSA seems to be unnecessarily complex and is not in line with current risk management practice. This relates especially to the proposed cash-flow

decomposition and the requirement of calculating present values creating new discounting curves (including credit spreads).

The described cash-flow decomposition method is not based on existing risk measures and curve creation procedures (which are subject to intensive validation). This would reduce the quality of RSA results with no additional benefit. A setup on existing infrastructure and validated inputs/results would be a much better option.

- The proposed discretion of national supervisors to lower risk weights in the default/spread risk framework disturbs a level playing field (§153).

  Double counting between CSR and IDR: in the current proposal for RSA there is no consideration of a potential overlap/double counting between Default Risk Charge and Spread Risk Charge. As an alternative we propose that IDR should be relative to CSR, i.e. losses from CSR should be deducted from IDR.

5. Liquidity horizons

The proposed classification of financial instruments and the timeframe of the buckets seem to be wrong and inconsistent with real market conditions. Even after the collapse of Lehman Brothers it did not take more than one day to execute most interest rate and FX transactions. Therefore, the proposed liquidity horizons appear seemingly based on unrealistic and wrong assumptions.

Furthermore capital requirement calculations for illiquid instruments are already taken care of in the Prudent Valuation. We suggest to not include different liquidity horizons in the Value-at-Risk calculation, since the interpretation of the Value-at-Risk numbers will be very difficult and meaningless for internal steering purposes. Therefore the different holding assumptions for different asset classes should be considered only in the Prudent Valuation

and the Internal Model should be based on one single holding period for all asset classes as it is now.

6. Expected Shortfall Calculation

The proposal assumes that the banking industry is in the same situation as before the subprime crisis took place. Actually, a lot of new regulations have already been implemented since then and therefore banks should be significantly safer now. The latest financial crisis could under nowadays rules (Basel 2.5 & 3.0, Dodd-Frank, EMIR) not have happened but it still serves as the basis for calculations. Considering this the proposed regulations seem to be way too strict and we suggest adapting the proposed confidence interval to a less strict level.

7. Treatment of hedging and diversification

The current draft proposes changes in the modeling of correlations within the internal model across the different asset classes and offsetting hedging positions. **If basis risk positions cannot be offset it** may actual **increase risks** in the bank because the business does not benefit from any hedging.

Detailed comments:

Page 16: Liquidity horizons:

For us the classification into 5 buckets is questionable. Why 5 buckets? Also the classification of risk factors is questionable. Are exceptions from this standard rule allowed? We would see e.g. no need that liquid FX currency positions should not be in the first bucket together with equities. Also the other classifications are not consistent with our assumptions we see on the market. Furthermore for illiquidity scenarios it is already taken care of in the prudent valuation scheme. We see an overlapping/double-counting here.

Comments directly to paragraph numbers in the Consultative Paper (starting on page 48):

§10: Instruments in the trading book:

How is a "net short risk position" exactly defined? Especially from the view of a bank with different trading desks; further clarification is needed.

§11: General presumptions for instruments:

All options should be included in the trading book. Which exceptions from this rule are planned to be allowed or are no exceptions planned?

§19: Reports to supervisors:

"Inventory ageing" is a rather unusual term. What is exactly meant by it?

§23: Definition of trading desks:

The definition of trading desks is a very important topic. Here further clarification is needed e.g. what size or structure a trading desk must have. Does it have to be aligned with organizational structure or can trading activities be done by specification into asset

classes? Does every change in organizational structure need an approval by the supervisor?

Model-independent assessment tool for desks:

Further clarification about this assessment tool is needed. Who is deciding about the shape of this framework? Is it a common approach for all banks or an individual solution per bank?
On the one hand Value-at-Risk shall be replaced by Expected Shortfall, but on the other hand for back-testing purposes on the trading desk level; once again a value-at-risk-calculation is necessary. In the end more calculations have to be carried out.
For an easy business model the Standardized Approach is allowed on its own. How is the boarder exactly defined with regards to the business and size of a bank?

§51: Cash Flow decomposition of Bonds

The decomposition of a fixed bond into cash-flows for the FX risk framework is overly complicated. The FX risk of a bond is connected and managed according to the current market value.

§52: Floating rate instruments

Taking only the fixed payments of a floating rate instrument for the general interest rate framework it does not give correct interest rate sensitivity. A “plain floater mapping” as it is used in the current standardized approach should be used. As above, for the FX risk framework the current market value should be used, no decomposition of cash flows should be imposed.

§59, §76: Swaps

Please see our comments as of for bonds and floating rate instruments above.

$91ff: General Interest Rate Risk (GIRR)

In §95 it is stated that only fixed cash flows should be included. The proposed treatment of floating rate instruments is inconsistent with risk management practice. A plain floater mapping approach (mapping notional to next fixing date) should be applied instead.

The proposed treatment of off-setting cash flows in buckets (§97) by a factor of 0.9 is highly disturbing the risk sensitivity of the approach for large but balanced portfolios (e.g. derivative portfolios with high number of trades and resulting low net risk). Such treatment will give high residuals positions per Vertex that do not reflect the true interest rate risk of the portfolio.

Furthermore the set-up of a discounting curve is very complex. It is questionable whether the final results of discounting cash flows bring added value to risk measurement.

101ff: Credit spread risk for no securitizations

The Risk Weight Matrix for buckets starts with a bucket of maturities up to five years. Short term instruments (money market, T-bills, short dated bonds) would be extremely punished. Lower credit duration would significantly reduce credit spread volatility. Therefore it is proposed to include more buckets on the short end of the matrix (e.g. > 3m, 3m – 1y, 1y-2y, 2y-5y).

Risk weights are partially very high for single exposures with limited diversification potential in a portfolio. Additionally overlap between the CSR risk weights and default risk needs to be addressed.

137ff: FX risk

The approach is inconsistent with the economic currency risk resulting from an open currency position. Splitting into cash flows and discounting, mapping onto 3 time buckets would deviate from real FX-risk for all instruments that have a Present Value.

The inclusion of FX risk outside of the trading book (i.e. “rest of the bank”) is unclear. Would banks need to split cash flow of all other banking book positions in a similar complex way? A market value approach for all trading book assets and book value approach for banking book assets would be more realistic. For derivatives a Delta-approach can be used.

The allocation of cash flows into 3 buckets is highly complicated for all products of the balance sheet (need to involve all future payments, floating rate cash flows a.s.o.).

Higher Risk weight for single currency exposure compared to current treatment (new: 15%, old 8%) with limited diversification effects due to regulatory correlation parameter of 60% will result in a higher capital requirement.

146ff: Default risk for non-securitizations

Current default risk weights are rather high and show significant cliff effects between the different rating categories. In lower rating classes there is a potential high overlap to Credit Spread Risk.

Would this apply for banks holding the paper outside the country? What does funded in same currency mean (e.g. term funding, generally all bonds are funded in the issue currency)?

§153 indicates national discretion for certain government paper. This will potentially destroy a level playing field between countries. One question is then whether the lower default risk weight should also be reflected in the Credit Spread Risk.