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FINANSINSPEKTIONEN
FINANCIAL SUPERVISORY AUTHORITY

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Unrestricted

Prudential Supervision

Comments on the Basel Committee Consulting Document on "Fundamental review of a trading book: A revised market risk framework"

Basel Committee on Banking Supervision published in October 2013 a consultative document on the "Fundamental review of the trading book: A revised market risk framework". The Finnish Financial Supervision welcomes the opportunity for consultation on the revised market risk framework. Specifically, we would like to share the following comments:

1 General comments

Finnish Financial Supervision welcomes the opportunity to comment on the second consultative document on the fundamental review of the trading book. We support the effort of the Basel Committee to ensure that financial institutions hold a sufficient amount of capital against institutions' risk exposures.

We support the general principle, to bring trading book requirements closer to those of the banking book. Also the objective to enhance transparency is supported. Further we believe that Committee's consideration to introduce standardized approach as a floor or surcharge to the models based approach is worth studying and could improve the overall capital framework, which might have been a bit too reliant on banks' internal models in certain cases.

We have some concern about the revised standardized approach that aims to act as credible fallback to internal models, but should not require more sophisticated measurement of market risk. We agree with the intention to have the revised standardized model to act as a credible fallback to internal models. However, we believe that the revised standardized approach will be too difficult for small banks. Therefore, we encourage the Committee to study this further to ensure that workable solution could be found that fits also to the small banks, which have only limited resources and are not creating significant risk for the system.

2 Specific comments

A revised boundary between the trading book and banking book

We acknowledge that the new revised boundary developed by the Committee seeks to address weaknesses in the boundary by reducing the possibility of arbitrage and by providing more supervisory tools. We support the new framework that is more likely to be aligned with banks' own risk management practices relative to the valuation-based approach. We support Committee's requirement that all trading book instruments must be fair valued daily and valuation changes must be recognized in the bank's profit and loss account. We also support the requirement to keep items in the regulatory trading or banking book once initially designated. We support the improved supervisory powers to assure better comparability among banks and the intent that the banks are required to provide documentation on valuation and evidence on all trading book

positions. Further we believe that by giving the supervisor the authority to require a bank to re-designate a given instrument to either the trading or banking book will improve the comparability between banks.

A revised risk measurement approach and calibration

We support the desire to introduce the expected shortfall in order to better capture "tail risk", but we have some hesitation to expected loss.
In identification of modellable risk factors we have some concern whether 24 observations per year is adequate enough to meet the requirements for a risk factor to be classified as modellable. We also believe additional guidance should be provided how to calibrate and calculate capital requirements under the revised internal market risk approach.

The incorporation of the risk of market illiquidity

We support the objective to better reflect market liquidity within the risk measurement; however, we have some concern how an objective allocation of financial instruments to five liquidity horizon categories can be achieved and how to incorporate the risk of market illiquidity and proposed capital add-ons during stressed market conditions. We believe additional guidance is needed here to assure consistent application between desks that trade complex products. Further we believe additional guidance is needed how to incorporate large positions, which might have an impact to price levels, into different liquidity horizons.

We agree with Committee's concern around excessive reliance on market risk models that use historical price volatility to deliver capital charges. Furthermore, we have some concern how to define the products or desks for additional risk assessment. In general we believe that a higher capital charge should be introduced for illiquid and complex products, to better address the risks. We believe that additional studies and guidance will be required.

A strengthened relationship between the standardized and the models-based approaches

We support the desire to strengthen the relationship between the revised models based approach and revised standardized approach. However, if they produce too similar capital charges this will weaken incentives to develop internal models.

A revised internal models-based approach

We agree with committee's view, that current internal-model approach has still some weaknesses, although Basel 2.5 introduced an additional capital charge based on a "stressed VaR" calculation will bring some improvements. The committee wants to address the weaknesses with the current risk measurement under the internal models-based approach. The revised approach strengthens requirements for defining scope of portfolios that will be eligible for internal models treatment.

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We have some concern how the model performance is verified and assessed on a trading desk level and believe some further guidance might be needed here.

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