



Comments

On the Basel Committee for Banking Supervision's Consultation Paper "Fundamental review of the trading book: A revised market risk"

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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Comments on the Consultation Paper “Fundamental review of the trading book: A revised market risk framework” (BCBS 265)

On 31 October 2013, the Basel Committee for Banking Supervision published its Consultation Paper “Fundamental review of the trading book: A revised market risk framework”. We appreciate the present opportunity to submit our comments.

I. General Comments

We strongly welcome the Basel Committee for Banking Supervision’s deliberations aimed at remedying the current framework’s shortcomings. However, more likely than not, the reform proposals will have far-reaching consequences regarding the future capital adequacy requirements for market risks under the standardised approach and the model-based approach as well as for default risks under the restrictive model-based approach. The proposals will trigger comprehensive amendments to the model structures. Also, banks internal organisational structures will be affected by the changes.

As a result of the new rules, the task of interpreting the new market risk metrics as well as deriving appropriate governance policies is becoming far more demanding. Furthermore, we hold the view that the implementation effort incurred as a result of the adjustments to the existing models will be very high. This does not only apply to banks with internal models but also to banks, which have to reckon with the introduction of the new standardised approaches.

We strongly support the simplification of the regulatory framework and the comparability of capital requirements (p. 4). The “Fundamental Review” should not be used as a backdoor for introducing yet another increase of the capital requirements. Rather, due to the conservative incremental approach under Basel 2.5, keeping the capital requirements within the international banking system on a constant level should be an officially stipulated objective.

Concerning the revised standardised approach, we recommend a clear description of the calculation of the capital requirements. Furthermore, we suggest that the use of the different risk weights and correlations should be confined to cases where these parameters feature material differences and where the nominal positions can be assigned on the basis of features that can be easily observed.

The excessive standardisation in the context of the internal models harbours certain dangers. Hence, in conjunction with excessively restrictive supervisory requirements, an excessive standardisation may, *inter alia*, lead to a rift between the supervisory model for calculating regulatory capital and the model used for internal purposes, particularly for the purposes of economic risk control. This applies especially to those cases where the model imposed by the supervisor is no longer suitable for the purposes of “daily use” in risk management and risk monitoring. In such an event, it would be equally impossible to continue compliance with the use test (a procedure, which we welcome on principle). Moreover, during periods of crisis, such an excessive standardisation may trigger herd behaviour on the part of banks.

Establishing the new standardised approach, which will become mandatory is already complex *per se*. In combination with the aforementioned rift and our concern that there will no longer be any capital-based incentives in the future for the transition from the standardised approach to the model-based approach, the incentive for a continued use of internal models for the purposes of calculating the own fund requirements will be eliminated. In this case, more likely than not, there will hardly be any bank which will voluntarily choose the model-based approach.

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One of the driving forces behind the increasing complexity in the model-based approach consists in the envisaged analysis of all risk factors which – whenever individual risk factors cannot be modelled sufficiently – in turn again lead to respectively separate risk charges. Any unnecessary increase in the complexity of bank’s internal processes and supervisory processes should be avoided to the greatest extent possible.

The Basel Committee’s current proposals include a whole range of qualitative requirements for risk management of trading book exposures. At this juncture, we hold the view that respect for the tested and tried principle of proportionality is paramount. For instance, we assume that the risk policies in the current form shall be primarily addressed to model banks (p. 50f). By way of clarification, we would welcome an addition that the model banks shall, furthermore, merely have to comply with these requirements on the basis of the scope and complexity of their transactions. In addition to this, we would appreciate a confirmation that the subdivision of trading desks as referred to in the present paper will only apply to banks with an internal model. If and when only the standardised approach is being used, there should be no expectation to establish trading desks for regulatory purposes.

We have strong reservations that supervisors will have to become explicitly involved even more in the organisational set up and thus may interfere with banks’ risk management: Hence, as far as we can see, this will e.g. mean that the establishment of individual regulatory trading desks including their strategic alignment will only be possible subject to supervisory approval.

There is a risk that the supervisor will be able to increasingly assign certain items to the trading book or to the banking book, thus, by default, indirectly dictate risk management policies. This would constitute a growing interference with the banking management’s autonomy or, moreover, a restriction of entrepreneurial freedom - whilst the responsibility for the consequences of such actions would remain incumbent upon banks.

Furthermore, from our point of view, if and when prior to internal restructurings in the trading business explicit supervisory approvals were to become necessary, the business strategy realignment or, moreover, reorganisation would become more sluggish.

Given the material changes, longer transitional periods for the implementation will be necessary also after implementation for the purposes of the QIS. This similarly applies to the standardised approach and model banks. After all, both would have to at least build one completely new process. Concerning the existing internal models, there should be a clarification that, on the one hand, their usage will remain permitted and, on the other hand, returning the model permission is an option.

In future, the envisaged model approval process will allow a partial use at the level of trading desks. In order to prevent a clear increase of internal transactions potentially undertaken for the sole purpose of establishing trading desks for certain risk types only, we recommend additionally keeping the option of the “old” partial use concerning risk types at the level of desks in the model approval.

In our view, it will hardly be possible to carry out a comprehensive Qualitative Impact Study (QIS) between the beginning of February and the end of April (which was the initial timetable). Apart from the insufficient time for preparation, at this point in time, considerable bank resources will still be tied up by the onsite inspections as part of the Asset Quality Reviews. In our view - should a QIS have to be carried out for the trading book on the basis of banks’ real trading portfolios – the earliest point at which this would become feasible is the end of 2014. Also, there are a number of requirements which have not yet

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been specified in sufficient detail, meaning that, at present, a practical QIS implementation would be virtually impossible for banks.

Hence, we welcome the revised plans, i.e. beginning with a QIS for hypothetical benchmark portfolios starting from January until the end of April 2014 followed by a comprehensive QIS between the end of July and Mid-October 2014. Notwithstanding the foregoing, this timetable remains very ambitious considering e.g. the requirement of a completely new implementation of the new standardised approach.

Furthermore, the QIS remains silent on the envisaged calibration level: In our view, it would be appropriate to keep the systemic capital level stable on the basis of Basel 2.5. We would like to reiterate that the capital requirements established thereunder are sufficiently conservative (which is partly owed to the additive approach). Furthermore, during the calibration it should absolutely be ensured that the transition from the standardised approach (SA) to the internal model-based approach (IMA) features a capital incentive.

Upon concluding the QIS, we suggest a public announcement (in an aggregated form) of the results as well as of the final conclusions drawn. Given the frequently lacking sufficient specification of the requirements under the second Consultation Paper, we hold the view that it would be appropriate to carry out a further consultation round after the QIS and after the preliminary definition of the outstanding issues. There are a number of major examples illustrating this insufficient specification: Including but not limited to the model independent “risk assessment tool”, the decision and inception of the floor / surcharge, the calibration of the IMA versus the standardised approach, a series of definitions under the standardised approach and many more issues. Hence, we welcome the TBG idea of refraining from a finalisation of the new framework prior to the end of 2014. In our opinion, this changed timetable also allows enough room for a third consultation round. At this juncture, quality should have the highest priority. This is especially true given the fact that the requirements currently in effect under Basel 2.5 are conservative, to say the least.

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II. Specific Comments

1. The trading book/banking book boundary

Whilst, in principle, we welcome the revised boundary approach since it is a further development of an intent-based definition, we hold the view that the excessively restrictive rules for the reclassification between the trading book (TB) and the banking book (BB) after the initial assignment has taken place are not always constructive. With regard to the trading book boundaries, banks need a reliable orientation based on the actually underlying trading intent. This has to be achieved by means of an unbureaucratic boundary and a reclassification policy that is fit for purpose.

We hold the view that it is inappropriate to preface the key criterion of the trading intent with the additional creation of rebuttable presumptions. This approach increases the red tape for defining “exceptions” which do not constitute exceptions within the meaning of the key criterion of the trading intent. Furthermore, the definition of the exceptions would always be predicated on the trading intent, anyway. In light of the above, we do not see any need for an approval process. From our point of view, a pure notice would be sufficient.

Unless the list of rebuttable presumptions is dropped, we suggest that banks define said list of rebuttable presumptions individually as part of the policy that is already envisaged, anyway. This could be approved as a one-off exercise by the supervisor.

We have considerable doubts whether it is possible to carry out an unambiguous assignment of the respective instruments to the TB or BB on the basis of observed features (p. 48, indent 9). In our understanding, for instance identical securities may be assigned both to the TB and to the BB and we would appreciate a corresponding clarification. The existing difficulties in this context are further compounded by the fact that the term trading desk is unclear. At this juncture, a specification would be helpful.

The option of simultaneously holding exposures arising from the same instrument both in the trading book and in the banking book is vital and should absolutely not be abandoned. For instance, as part of the liquidity reserve under the German Commercial Code, there are products which have to be simultaneously held both in the trading book and in the banking book. We kindly request taking this into account in the regulatory text.

In a number of regards, we hold the view that the rebuttable presumption (indent 11) is excessively far-reaching (e.g. regarding funds (d) or listed equity (e)). We are of the opinion that, in both cases, this perspective is too simplistic. Whilst we recognise that it is useful to prevent any abusive shifts of a bank's trading activities e.g. as a result of issuing a special fund, in every individual case there will be a need to review whether the requirements under indent 4 are being met (p. 48).

Under indent 11, the Consultation Paper sets out that fund shares featuring a look through option (derogations are regulated under indent 13 (d)) shall generally have to be assigned to the trading book. The rationale behind this approach is not immediately obvious to us. For many banks, it will be advantageous to pool their (strategic) banking book investments by means of an investment into a fund. If and when

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the look through is an option at this juncture, the respective securities in a fund should not receive any different treatment to the way in which they would be treated if these securities were held directly in the banking book. Since the introduction of Basel II, the European Union applies tested and tried rules for the look through approach; this basic tenet is revisited in the Basel Committee paper “Capital requirements for banks’ equity investments in funds” (BCBS 266) published in December 2013. Hence, the general assignment to the trading book suggested in the trading book paper is at odds with the basic rationale underlying the BCBS publication “Capital requirements for banks’ equity investments in funds”.

According to the list of presumptions, on the one hand, all options will have to be held in the trading book, on the other hand, derivatives on certain instruments will have to be held in the banking book. We suggest resolving this contradiction.

The dependence on accounting rules under indent 11 a) is incompatible with an intent-based definition. Hence, we reject the accounting approach and hold the view that point a) should be eliminated. By reverting to the definition in the accounting rules, the new definition also incorporates elements of the “valuation-based approach” (which had, quite rightly, been abandoned) thus incurring the disadvantages already referred to in our comments on the first Consultation Paper. Whilst not limited to, these disadvantages include the fact that the supervisory definition will depend on decisions by the standard setters for international and national accounting rules.

Similar to the list under indent 11, also in the list under indent 13 it should be possible to demonstrate the need for a TB assignment (e.g. with regard to “unlisted equity” (rebuttable presumption)). In our view, as far as such equity instruments are concerned, the absence of market prices cannot be deemed a viable reason. Otherwise, this list would e.g. also have to include loans against borrowers’ notes which are widespread in Germany and which are frequently and, quite rightly, assigned to the trading book.

From our point of view, it remains unclear how it can be prevented that hedges are torn apart e.g. in the case of mandatory BB items which are being hedged by means of mandatory TB items or vice versa. Hence, under the provisions of indent 11(a) in conjunction with footnote 20 of the proposal, “held-for-trading instruments” should be assigned to the trading book. Under the provisions of IAS 39.9 (a) iii, all derivatives are designated as held for trading. This also includes derivative investments made for the purposes of economic hedging of banking book positions. If a future assignment of these derivatives to the trading book was required, there would be a book mismatch i.e. exposures in need of hedging and hedging instruments would be assigned to different books. As a consequence, contrary to the economic intents and purposes, the hedging instrument would result in an open position which would require capital backing. This would further amplify the rift between capital management for economic purposes and capital management for regulatory purposes.

The handling of reclassifications is clearly too restrictive. Strict reclassification rules or, moreover, *de facto* reclassification prohibitions could, for instance, lead to a situation where exposures would have to remain in the trading book although short-term trading will no longer be an option (e.g. in the case of stale positions). This may potentially be at odds with the boundary amendment’s original underlying rationale,

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i.e. the assignment of an exposure based on its risk management. Reclassifications thus present the only tool for a potentially necessary subsequent correction of the book assignment and thus a “transfer” of the transactions so that the respectively adequate method for determining its regulatory capital adequacy requirements may be used.

Provided that only the trading intent at the beginning would have to be considered, this would reduce a predication on the trading intent as a material criterion *ad absurdum*. Due to the fact that the last doubt concerning the absence of arbitrage options should have been eradicated as a result of the surcharged own fund savings, we see no danger even in a repeated reclassification.

Furthermore, there are substantive technical requirements for calculating a capital add-on after reclassifications. Generally, in a trading book definition that remains intent-based it needs to be possible to carry out a book change; this should not only be an option in exceptional situations. Due to the current absence of cherry picking opportunities, there is no longer any need for a restrictive approach in handling the issue of reclassifications options, either.

Furthermore, we have certain reservations over the future role of the supervisor in the context of reclassifications. At this juncture, given the explicit mandatory involvement of the supervisor in every reclassification, we are afraid that the processes will tend to become increasingly sluggish. One further source of concern is that the supervisor may single-handedly impose reclassifications thus (at least indirectly) interfering with banks' management and risk control.

The Consultation Paper calls for comprehensive documentation requirements which banks would have to comply with concerning all of their trading book exposures. For supervisory authorities, the documentation should make monitoring the boundary between TB and BB exposures easier. In our view, the documentation ought to be confined to material information. We propose reconsidering the documentation requirements.

2. Internal Model-Based Approach (IMA)

a. Scope

We see no reason why an internal model-based approach (IMA) should no longer be an option for the correlation trading portfolio (incl. nth-to-default credit derivatives). The model standards required under Basel 2.5 have set the bar extremely high; similarly, also market structures are subject to stringent requirements (e.g. the condition of the “two way liquid market” should be mentioned in this context). Furthermore, we hold the view that the requirements contain very conservative presumptions concerning the risks of this trading activity (e.g. concerning the holding period and the confidence levels thus, on the whole, constituting a good basis for continued fitness for supervisory purposes. As a result, we petition upholding the Basel 2.5 model scope also in a revised market risk framework.

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b. Returning the model permission

The reforms to the fundamental review will lead to a profound review of the trading book regime. Under these circumstances, we hold the view that it would be appropriate to allow banks once again to freely decide whether they wish to use the model alternative (provided the latter qualifies for a model permission) or whether they wish to use the standardised approach. Contrary to the policy to date, upon introduction of the new rules, a “return” to the standardised approach should be an option for banks on a formal and *de facto* basis. Many banks took the decision to calculate their capital charges on the basis of their internal models as early as in the mid-1990s. Since the conditions now are fundamentally different, we hold the view that this decision cannot possibly remain legally binding.

c. Desk-Level Approach/Partial Use

Whilst we essentially welcome the desk-level approach, the number of supervisory desks should not become too high (approx. 20-30) and ought to be based on the bank's internal organisational structure. Otherwise, this will result in considerable knock-on effects as well as costs. This would, for instance, affect the area of the approval process, model changes, back testing and the desk-level P&L attribution process. Also, the correct treatment of internal transactions becomes more of an issue when there are a growing number of desks requiring a supervisory definition. We fully support the proposal that the decision as to which desks are deemed “in-scope” ought to be incumbent upon banks. In our opinion, this flexible partial-use option is highly constructive. We also subscribe to the comment that the selection of “in-scope” desks shall not be made on the basis of cherry picking considerations.

The current Consultation Paper no longer mentions the remediation period for trading desks that no longer meet the requirements (backtesting, P&L attribution). This should be incorporated once again.

Appendix A, key element #3 calls for the individual trading desks to report, at least once a week, “desk VaR/ES sensitivities to risk factors”. This goes far beyond the scope of the current reporting requirements and would hardly be feasible in technical terms.

d. Risk metric / Outlier sensitivity

We still doubt that the transition to the expected shortfall (ES) constitutes an advantageous development *per se*. We still doubt the validity of the points made in case: Allegedly, improved capturing of the tail of the loss distribution (particularly whilst factoring in the IDRC requirements during the analysis), the lacking sub-additivity feature of the VaR risk metric (which is merely a theoretical issue and does not create any problems in real banking operations) as well as the arguments concerning the gaming danger or, moreover, the incentives for traders. At this juncture, we would like to refer to our comments on the first Consultation Paper (p. 5 - 7).

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According to our analysis, the reduction to the 97.5% quantile is insufficient for resolving the issue of the higher outlier sensitivity. Once again, we would like to refer to our petition submitted as part of the GBIC comments on the first Consultation Paper where we called for a quantile of 95 or 90%.

Potentially, a transition to the expected shortfall for measuring market price risks in Pillar I may trigger inconsistencies in the risk measurement and risk aggregation of the different risk types under Pillar II. Hence, from our point of view, at least there shall and must not be any automatism for a transfer of the expected shortfall also as a risk metric into Pillar II (c.f. our comments regarding the first Consultation Paper).

e. Factoring in market liquidity

We welcome the fact that apparently there are plans to factor in the so-called “endogenous liquidity risks” as part of the prudent valuation requirements. It is paramount to avoid any double counting of the liquidity risks in the different regulatory requirements.

We wonder to which extent factoring in market liquidity in the modelling over five liquidity horizons is compatible with the (still existing) “short term condition” of trading book exposures (particularly the one year liquidity horizon). We would appreciate a clarification whether there now is a need to increase the short-term criterion to 1 year in general.

We hold the view that the requirements listed in the table concerning the envisaged liquidity horizons for certain instrument classes are overly descriptive and detailed (cf. e.g. table 2, p. 16). Upon a review by the authorities, granting derogations should become possible. The rationale for allocating the “FX rate” to the 20 day bucket seems counter-intuitive to us. More likely than not, an assignment into the most liquid 10 day bucket would be more appropriate at this juncture. On a more general note, as part of the QIS, we suggest querying banks in order to obtain information on the liquidity horizons’ granularity as well as their duration, thus, at this juncture, using the QIS also for consultation purposes.

The first Consultation Paper discussed the pros and cons of three options for including market liquidity into the internal model. The second Consultation Paper defines option 1 as the “baseline approach” for the upcoming QIS. Whilst this issue was already described in the first Consultation Paper, the problem of the so-called “overlapping return” (Section 1.3, p. 13 as well as Annex 1, D.3. indent 181 c), p. 86) with amplified autocorrelation problems becomes particularly salient at this point.

We would like to reiterate our support for option 3 already expressed in the GBIC comments on the first Consultation Paper (one-day-shock with uniform scaling option). Along with the ongoing data maintenance and validation costs incurred in every case, the introduction of different liquid horizons as part of the calculation of the market risk metric would not only lead to considerable one-off model and system adjustment costs, but potentially also to several partial risk amounts of the same book which are no longer directly compatible. At this point, for the purposes of an aggregation of the risk metric at the book level, it would subsequently anyway (for instance for the internal reporting system) become necessary to

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carry out a scaling exercise that is similar to option 3. Furthermore, in the proposed approach, the results no longer lend themselves to an interpretation. The reason for this is that assumed “simultaneous” scenarios (e.g. in a historic simulation) de facto did not occur simultaneously. Hence, there is not the least guarantee that this approach will lead to conservative results. The uniform calculation on the basis of a one day shock and the subsequent scaling on the basis of a uniform liquidity horizon would clearly reduce the implementation effort, thus leading to risk metrics which lend themselves to an initial comparison whilst still meeting the Basel ideas.

In addition to this, such an approach would facilitate a better distinction between an internal core model which may continue to be deemed appropriate for internal risk management purposes (cf. also 14 Use test below) and a supervisory model under due consideration of the liquidity horizons that are strongly driven by supervisory concerns. At the same time, this could reduce the problems surrounding backtesting (test of a different model than the one used for supervisory purposes) as well as the P&L attribution problems described below.

In our view, the complexity envisaged during the calibration of the ES to a stress period on the basis of a history starting from 2005 would generate huge costs which are unnecessary. The years 2005/2006 featured rather quiet market phases. Hence, more likely than not, the “benefit” of a conservative risk calculation will bear no relation to the implementation cost. Also, more likely than not, it will be difficult to find a reduced set of risk factors which dates back to this period whilst simultaneously meeting the “explanation rate” of currently 75% (cf. p. 19, 1.4 (ii); p. 86, indent 181 (d), (f)). The calibration on the basis of a history starting from 2008 (no earlier than the end of 2007) is therefore sufficient. We can indeed also imagine that the stress period will be stipulated directly by supervisors. This would be a further contribution towards standardisation aimed at reducing diverging results of identical portfolios in different banks.

Basically, we welcome the proposed option of a simplified calculation of the ES for the crisis period on the basis of a reduced risk factor set. However, in combination with the proposed scaling of $ES = ES(R,S) * ES(F,C) / ES(R,C)$, this approach increases the technical and process-related complexity as well as the number of necessary simulation runs. In order to improve the number of required calculation as well the complexity in the form of a multiple definition of risk factors for the production process, we would welcome it if the scaling factor $ES(F,C) / ES(R,C)$ would have to be recalculated not on a daily basis but only in regular intervals (e.g. semi-annually, annually). Waiving the calculation of the scaling factor should be an option where a bank is able to determine also the ES for the crisis period on the full risk factor set in the absence of significant proxies; after all, in this case, the scaling factor would equal 1, anyway.

Similar to indent 181, the average of the daily capital measures as the second element of the aggregate capital requirement should be calculated consistently on the basis of 60 days (indent 189, on the other hand, refers to 12 weeks).

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f. New “Risk Assessment Tool”

We strongly object to this new tool. The new tool has not been sufficiently specified (e.g. level of the thresholds). Furthermore, the treatment of different desk structures in different banks remains unclear. Also, the conditions under which desks that fail to pass this approval test may subsequently be subsumed under internal modelling are unclear.

It is not immediately obvious in how far this tool furthers the objective of identifying desks with complex, potentially illiquid instruments featuring elevated model risks or, moreover, specific dangers of “jumps in liquidity premia” (JILP). A low “risk density” may have many plausible causes and it is not necessarily indicative of modelling problems. We do not hold the view that the present tool is suitable for becoming a third – let alone equivalent – validation tool along with backtesting and the P&L attribution process. It is entirely sufficient to use the two aforementioned tools for identifying desks that are suitable for internal modelling. Based on the foregoing, the current proposals in this regard should be dropped.

Concerning the calculation of the exposure measure, the leverage ratio framework is incorporated by reference. This is a reference to a framework which currently reflects e.g. netting options in an entirely insufficient manner. Furthermore, only measurement approaches which overstate the exposure are allowed. For the market risk area, this is inappropriate. The use of the leverage ratio’s exposure measure is also inappropriate because e.g. for bonds, the market value cannot constitute a meaningful proxy for an expected capital requirement; furthermore, when it comes to derivatives, the CEM / NIMM exposure measure depends on whether regulatory netting is allowed and whether collateral is available or not. As far as counterparty risk is concerned, this is surely useful. However, it is not a useful proxy for market value fluctuations.

The risk assessment tool also competes with the envisaged floor in the absence of any obvious reason why the combination of both instruments is supposed to lead to a consistent result.

g. Capturing of diversification effects

We strongly welcome the fact that the proposal submitted by the international banking associations has been heeded. Notwithstanding the foregoing, we would prefer a p-estimate on the basis of individual banks.

h. Further model limitations

Parametric approaches: In our preliminary understanding - as far as the content is concerned - the new proposals will not trigger any compelling need for a simulation approach. Hence, also variance – covariance approaches should remain an option (cf. indent 181 g) p. 87. We recommend deleting the addition “supervisors may permit banks to use models based on either historical or Monte Carlo simulations”. More specifically, we would like to explicitly point out that parametric models allow the modelling of distributions that are not normal for instance by means of Johnson or Fourier transformations and using scew-

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ness, curtosis, fat tails etc. Similarly, it is possible to calculate the ES and to consider different liquidity horizons - the latter e.g. by time horizon specific volatilities.

Full re-valuation: There should be a clarification that a full re-valuation cannot be expected from each and any instrument (including complex instruments). Once eligibility has been proven, the continued use of approximation approaches such as delta-gamma needs to remain an option.

i. Backtesting

Notwithstanding the foregoing, the proposed pragmatic and familiar approach does not constitute backtesting of the ES-parameter; after all, backtesting of the 1-day VaR is no backtesting for an expected shortfall which is based on different liquidity horizons. Rather, there is only a loose connection between the outlier counting to two quantiles and the quality of the ES estimate. Hence, using the backtesting results in order to derive an automatic model rejection mechanism is inappropriate, (cf. p. 8). At this juncture, supervisors need discretion for their decisions in evaluating the backtesting results. This should also allow to not count individual outliers if it can be demonstrated that the outlier is not due to model failure. Also, there should be a deadline for remedying shortcomings prior to the removal of desk approvals (cf. p. 9).

j. P&L-attribution process

We welcome the fact that the Basel Committee recognises that P&L deviations are not necessarily indicative of modelling problems. Hence, however, also the quantitative requirements for the “degree of fit” should be interpreted cautiously and in a discussion with banks. In our view, there shall and may not be any automatism between exceeding the deviation limits and removal of the model permission for the respective desk.

There should be a common and unambiguous use of the different P&L terms in the context of backtesting and P&L attribution (“risk theoretical P&L”, “actual P&L”, “theoretical P&L”, “hypothetical/actual trading outcomes” etc.). At this point, we suggest establishing consistent and meaningful requirements.

k. Model for default risks

On principle, we welcome the limitation to default risks (default-only-mode) since it helps to avoid double counting. However, this creates a need to adjust existing IRC models. It is doubtful whether these adjustments will be deemed fit for purpose within banks or whether a pure “supervisory model” is being established at this juncture. We tend to believe that the latter will be the case.

In terms of the models available under the current framework (Basel 2.5), it is technically already possible to avoid double counting also by means of capturing migration risks primarily within the existing default models (IRC models). We see no objective reasons why this internal modelling (which has already received supervisory permission) cannot be continued. This might spare banks from considerable imple-

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mentation burdens. Whilst, in the IRC model, it is relatively easy to make adjustments towards an IDRC model, it is, however, far more onerous to adjust the model for “continuous risks” (which is referred to as “market risk model” in the current proposals) in order to accommodate the new requirements.

There should be a clarification that instruments featuring a zero default risk (such as certain derivatives, e.g. interest rate swaps) do not have to be included into the default risk model. For such instruments, there should only be a capital charge for counterparty default risks.

We have doubts whether share prices are always an appropriate basis for estimating default correlations. Hence, we feel it would be useful to also allow other internal estimation methods which are being reviewed by supervisors. Also, the determination of e.g. correlations for sovereign bonds is unclear.

In our preliminary understanding, contrary to Basel 2.5 (where this refers primarily to convertibles) all equity instruments will, on principle, have to be included in the default risk modelling. We do not hold the view that this is necessarily a good idea. We would appreciate a clarification whether this preliminary understanding is correct.

The rationale provided for limiting the modelling discretion under the default risk model is not immediately obvious in all respects. In our view, the observed, relatively high deviations in the RWAs calculated using the currently deployed models in the Basel comparison study can be explained (to an extent that is not negligible) by the fact that a number of the models compared have not yet been allowed the permission by the national supervisor and were thus not subject to the same restrictive requirements as the other models.

Due to the fact that the two factor model is an entirely new model, significant time will be required for an appropriate implementation (detailed model development, test, validation etc.); this lead time will be indispensable and should be granted to all banks. This should also be taken into account during the QIS. Also, there has been no specification as to which factors are concerned and the extent to which they correlate with each other or, moreover, to which extent this correlation can be determined by means of share prices.

I. Calculation of the capital requirements

In light of the further development of the prudential supervision rules, we hold the view that - in future - the application of the multiplier $3+x$ will be dispensable.

In our understanding, the capital requirements for “not-in-scope” desks are being added up individually. To us, the rationale as to why the desk definition is being maintained at this point is not immediately obvious; after all, it should be possible to calculate the capital requirement resulting from the standardised approach jointly for all desks (cf. indent 193, p. 96).

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m. Use-test

Apparently, the importance of the use test will decline further: It only plays a marginal role and is no longer being explicitly mentioned in the new Consultation Paper. Yet, on principle, we advocate in favour of maintaining the use test requirement. However, this presupposes the option of full or partial internal use of the regulatory models. At present, we do not assume this to be the case. Hence, any expectation of compliance with a use test is unrealistic.

In this context, we would like to point out that three different expected shortfall measures (current ES with all risk factors, current ES with reduced risk factors, stress ES with reduced risk factors) will have to be calculated for the calculation of the internal model; however none of these expected shortfall measures can be used for internal control purposes. This creates considerable costs in the absence of any benefit for banks for the purposes of their corporate governance

n. Qualitative standards

Indent 180(c) proposes that the initial and ongoing validation of the internal risk models shall be carried out by a “distinct unit” (distinct from the “risk control unit”). The requirement of carrying out the validation in a unit that is separate from the risk controlling unit is operationally unfeasible (whilst not limited to, this caveat particularly applies to smaller banks). The required independence of the validation from the development process can also be ensured by other appropriate means.

3. Standardised approach

We welcome the fact that the Basel Committee has decided in favour of continuing the “Partial Risk Factor Approach” and opted against a “Fuller Risk factor Approach”

Notwithstanding the foregoing, for the inception of the standardised approach, we support the alternative approach proposed by the IIF, ISDA and gfsma. We would clearly prefer a sensitivity-based approach over the currently proposed cash flow-based approach.

Depending on the final design details, we hold the view that (given the implementation of valuation models in banks today) the major part of the requisite sensitivity data is already available. Accordingly, compared to a cash flow-based approach, the implementation of the IT solutions for calculating such a standardised approach could be achieved at substantially lower costs.

In this context, it is worth noting that the detailed calculation of the sensitivities will often depend on the respective system; hence, the rules should provide a certain room for discretion. For instance, sensitivities in the interest rate risk will dependent inter alia upon the number and location of the yield curve’s support points and the interpolation algorithms that were used. Where the supervisor requires specific algorithms, existing sensitivities from the control systems may potentially not be usable for the reporting

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system. This would have considerable cost implications which would partly erode the advantages inherent in this approach.

a. Suitability for smaller banks

In our view a standardised approach for market risks will only be suitable for smaller banks if it can be operated without building a model infrastructure. This particularly means that it is not necessary to deploy pricing models, that there is no need for cash flow mappings and that a regular market data supply for input parameters aimed at calculating the capital requirements is not needed. The currently proposed standardised approach no longer meets these preconditions. *In lieu* of this, its complexity will have rendered it virtually unfeasible for smaller banks. Furthermore, in light of clearly dwindling margins in the original lending business or, moreover, commission-related operations, this standardised approach will trigger clearly higher implementation costs (technical, personnel-wise) particularly in smaller banks - although this is not factored into the existing business model which is structured in a simple manner.

One compounding element is the clearly increased complexity of the computation logic. The novel standardised approach is largely new. On the whole, this translates into considerable implementation costs; especially smaller banks will have difficulties in covering these costs over a sustained period of time. Given that, in future, various parameters shall be updated in regular intervals by supervisors, this means that such costs will not only have to be paid on a one-off basis by banks. Generally, we advocate in favour of a solution where complexity and appropriateness of the standardised approach feature a reasonable balance.

We therefore request streamlining the new standardised approach in a fundamental manner or contemplating an alternative and simpler, sensitivity-based approach.

b. Sufficient specification

In our view, the requirements regarding the standardised approach should be specified in greater detail. Whilst not limited to, this concerns e.g. the correct and unambiguous use of different terms (e.g. joint use of the ‘nominal value’ p. 49 and p. 90: The nominal value does not constitute the market value of an instrument). We suggest using every term for one meaning only (e.g. the nominal value on page 51 seems to designate the full market value and the bond’s cash flows at the same time). The specification is incomplete, e.g. it is lacking for securitisations; hence, at this point, an assessment is possible only to a limited extent. On a more general note, it remains unclear whether the proposed standardised approach is sufficiently risk sensitive.

Furthermore, we recommend describing the determination of an option’s “delta equivalent position” in an unambiguous manner. For instance, whilst the underlying of a cross currency option shall be the cross-rate between the two currencies, neither page 57 nor page 62 clarify how the “delta equivalent positions” are supposed to be determined in this case.

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In our view, a more detailed specification of the calculation of the capital requirements under the standardised approach is a *conditio sine qua non* for the Committee’s underlying objective, i.e. facilitating a comparison between the capital requirements. Given that banks would need to get in touch with national supervisors in order to clarify even simple products such as cross-currency options, it is hardly conceivable that there will be early answers facilitating a convergent and timely implementation. However, implementation would have to be convergent if the Basel Committee wishes to stay true to its principles.

c. Risk weights and correlation parameters

We welcome the fact that the revised standardised approach factors in hedging and diversification effects to a greater extent than the approach adopted to date. Notwithstanding the foregoing, in our view a better compromise between risk sensitivity and simplicity of the approach could be achieved if the differing risk weights and correlations would only have to be deployed if and when these parameters feature material differences. *Inter alia*, this should help to contain the costs for the practical implementation; whilst not limited to, this particularly concerns the changes to the IT systems. Furthermore, for the purposes of a harmonised implementation, we hold the view that the capacity to assign these parameters to nominal positions on the basis of readily observable features will be required. In this context, concerning the risk factors, there seems to be a need for the following simplifications.

d. Credit Spread Risk: non-securitisations

The Credit Risk Standardised Approach (CRSA) categorises the “sovereign risk” for banking book exposures. In our view, this categorisation should equally apply to trading book items. Based on the above, for buckets 1, 2, 6 (and 7, 8 and 12) we suggest using the definitions of the banking book (p. 66, indent 105).

The buckets 3 to 6 (and 9 to 12) should be pooled into a single bucket; during this exercise, certain categories of sovereign bonds would have to be removed from the buckets 6 (and 12) (p. 66, indent 105).

Furthermore, it is worth noting that - in the case of maturities of up to / more than five years - there is hardly any difference between the correlations for cash flows of identical issuers. For banks, the implementation costs for the correlations would clearly increase if banks had to gather data on correlations in line with the maturity of the cash flows from their trading systems and if they had to use and compare them for supervisory purposes. We therefore caution against a differentiation of the correlations on the basis of individual maturities (p. 68, indent 109).

e. Credit Spread Risk: securitisations

The rules on the credit spread risks for securitisations are based on buckets which refer to the product type, sector, creditworthiness and maturity of CDO and ABS/MBS exposures (cf. p. 70 f.). The selected bucket groups appear to be slightly arbitrary and incomplete. From our point of view, they do not reflect the securitisation markets in an appropriate manner.

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Hence, as far as securitisation exposures are concerned, a difference is being made between CDOs, MBS, Credit Card ABS and Residual (cf. p. 70, indent 115 ff). Yet, there is no risk bucket for the important segment of automotive-ABS. As a result, exposures from automotive ABS in the trading book would have to be assigned to the residual bucket.

The capital requirements in the residual risk bucket are clearly higher than in the other risk buckets. In addition, the regulatory capital requirement sees a further increase because, in the residual risk bucket, there is no recognition of risk mitigating diversification effects and hedging effects (cf. p. 71, indent 122). In future, for automotive ABS based on highly granular, high grade exposures collateralised by vehicles, the trading book capital charge would consequently be much higher than for corporate MBS or uncollateralised credit card ABS. When it comes to triple A rated exposures, the gross difference between automotive ABS and MBS e.g. amounts to approximately 67% whilst between automotive ABS and credit card ABS, this difference is approximately 36%. The net effects are bound to be clearly higher still. This is due to the fact that no diversification and hedging effects are recognised in the residual bucket. In our view this is not risk adequate. We suggest an adequate reflection of the automotive ABS segment which, after all is important for the securitisation market. Furthermore, also the presentation of the formula under indent 123 is unclear. This is due to the fact that it is unclear whether the square root term includes the residual bucket.

We also have difficulties in comprehending why diversification and hedging effects shall only be permissible for securitised corporate exposures (cf. p. 39 and 49). Especially for securitised retail exposures, due to the high granularity of the securitised portfolios, the unexpected losses are usually lower than for corporate exposures.

In general, correlation assumptions within and between buckets appear to be excessively conservative. Only zero diversification or independent aggregation (apart from effective hedge relations) shall be allowed.

Furthermore, the basis on which the risk weights for credit spread risks are being derived or calibrated is unclear. There also seems to be a lack of appropriate deliberations on the relations between credit spread risk and default risk, for instance, in the event of holding a AAA tranche and a BB tranche.

On the whole, the proposed regime would act as a strong disincentive for the assignment of securitisation positions to the trading book. Banking book rules contain no capital requirements for credit spread risks. This is at odds with our understanding of the Basel Committee’s intents and purposes pursuant to which preference should be given to a rule where the banking book and the trading book feature comparable capital requirements.

We strongly recommend synchronising the review of the trading rules with the rules for securitisations (BCBS 269) ensuring a consistent perspective with regard to securitisations between these two parallel regulatory activities.

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f. Default Risk: securitisations

We have difficulties in comprehending the rationale for the proposal of a 75% LGD for senior tranches (cf. p. 80, indent 169). Especially in the case of collateralised, securitised exposures (such as automotive ABS), this proposal appears to be inappropriate and exaggerates the loss exposure. Also, the fact that hedging shall only be an option for securitised corporate exposures but not for securitised retail exposures (contrary to common market practice in the field of automotive ABS) appears counterintuitive (cf. p. 80, indent 162).

g. Equity

For the sake of simplicity, we suggest aggregating the buckets 1 to 4 (and 5 to 8) into one uniform bucket (p. 72, indent 126). The risk weights for the four buckets are of a similar order of magnitude (p. 73, indent 127). This also applies to the correlations (p. 73, indent 129). In our opinion, for certain entities the determination will not be possible.

h. GIRR

We hold the view that the so-called “disallowance factor” for long/short positions (cf. 3.2 on p. 33; 3.4 (i) on p. 36; indent (3) 97. on p. 64) should be dropped; our reservations are owed to the fact that this factor would clearly overstate the risks of back-to-back positions (e.g., for instance, the client derivative micro-hedged through the market). Instead, for the purposes of factoring in (maturity) basis risk, the suggested linear mapping to the vertices could be replaced by a more risk sensitive mapping.

i. Options

We welcome the separate approach for options and the return to the logic of the old scenario matrix approach (with modifications). However, the different treatment of vega long and vega short positions (different volatility shifts, cf. indent 168 on p. 81) in the proposed scenario matrix approach leads to a situation where the back to back positions – such as the client derivative micro-hedged through the market - are seeing a clear exaggeration. This example illustrates that the sign of the vega does not constitute an appropriate tool for an adequate consideration of the basis risks referred to in the Consultation Paper.

j. Correlations

The different correlations for same sign / different sign lead to a clear overstatement of the commodity, equity and interest rate risk. Already on the basis of simple examples it becomes obvious that one individual trading transaction features a lower risk than this trade in combination with a micro hedge. In order to avoid undesired side effects in a larger (hedged) portfolio, we would like to suggest equating the correlation “same sign” and the correlation “different sign”.

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k. Examples

The presentation of “floating rate bonds” in the examples complementing the Consultation Paper is erroneous and does not reflect the real risk. According to example 4, the general interest rate risk of a floater bond (featuring a residual maturity of 7.26 years) would be identical to the interest rate change risk of a zero bond (featuring a maturity of 7.26 years). Thus, the general interest rate risk in example 4 would be overestimated many times over. By way of complete analogy, the presentation of an interest rate swap (examples 11 and 12) is not risk adequate, either.

The rationale for treating floating payments differently to fixed rate payments in the FX risk is not immediately obvious. For a fixed rate bond, the individual cash flows are assessed in combination with their respective residual maturity; for a floating rate bond, the market value for the aggregate maturity is taken into consideration. At this point, a consistent treatment would be preferable as well as – in the best case scenario – a simple solution (e.g. the market value or nominal value for the aggregate maturity).

4. Relation between the standardised approach and the IMA

a. Parallel calculation

Unless the requirement of a parallel calculation of the SA is dropped, it would be preferable if this calculation would at least not become necessary on a daily basis but only as per the reporting dates.

b. Floor / surcharge

We reject the supervisory requirement of a floor (or a surcharge) that is based on the standardised approach. A floor would constitute a massive disincentive for using and further developing an internal model. In addition to this, a floor may also create wrong incentives: Once the floor has been triggered, i.e. the model requirements are (x%) below the capital requirements under the standardised approach, there will be incentives for embarking upon transactions which increase the risk but do not affect the floor (or, respectively, the standardised approach results) - which, however, lead to higher capital requirements of the models. This would leave the capital requirements unchanged for as long as the floor is being triggered. This notion is based on the assumption that (especially in the case of more complex portfolios) the standardised approach does not lead to adequate measurement results.

5. Disclosure

The disclosure of the SA calculations incurs the danger that the model values will no longer be recognised e.g. by investors, although the latter might better reflect a bank's risk situation. Furthermore, the granular breakdown of the trading book information lacks an adequate cost benefit ratio given the accompanying implementation effort. We would suggest limiting the disclosure information to material aspects.

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In our understanding, the disclosures under table 1 (p. 118) would have to be prepared on a monthly basis. This is a departure from the usual semi-annual disclosure cycle. Whilst its benefit is doubtful, the costs will definitely be considerable. Therefore, we recommend semi-annual disclosure intervals.

6. Supervisory Review Process – the second Pillar

Apparently, there has been an editorial oversight: Under item no. 4 (p. 113) there is still a reference to the “modelling of specific risks”. Yet, in our understanding, the differentiation between general market risks - specific market risks shall no longer be made. We kindly request a correction.

Yours sincerely,

For the German Banking Industry Committee



Dr. Ralf Goebel



Dr. Silvio Andrae