



Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室
電話：2521 1160, 2521 1169 圖文傳真：2868 5035
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

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By email: baselcommittee@bis.org

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

Dear Sirs

Consultative Document on the Fundamental Review of the Trading Book

We refer to the second consultative document on the Fundamental Review of the Trading Book published by the Basel Committee on Banking Supervision (BCBS) in October 2013. On behalf of our members, we set out in the attachment our comments on the proposals in the consultative document.

Since the current proposals would introduce significant changes to the Market Risk regulation framework with a far reaching and fundamental impact to the industry, we trust the BCBS will thoroughly review and consider the industry comments before implementation. We would appreciate the BCBS' particular attention to the following views and concerns of our members:

1. We are opposed to setting a standardized-based capital floor as this will disincentivise banks to invest in developing and enhancing their internal risk models.
2. The proposed standardized approach is too complicated to implement with no value added to risk management while necessitating intensive investment in systems and human resources.
3. The proposed disclosure requirement is considered too excessive. Sensitive and detailed disclosure such as trading strategy, the desk structure and the trading size may easily be misinterpreted by the public.

We hope you would find our comments useful. For any questions, please do not hesitate to contact Mr Timothy Tam of the Secretariat at 2526 6080.

Yours faithfully



Eva Wong
Secretary

Enc.

c.c. Ms Karen Kemp, Executive Director (Banking Policy), Hong Kong Monetary Authority

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香港上海匯豐銀行有限公司
秘書 黃美嫦

Appendix - Comments on Consultative Document on the Fundamental Review of the Trading Book: A Revised Market Risk Framework

General Comments

The proposed framework will significantly increase the regulatory reporting burden to banks in general. More importantly, we are uncertain of the way ahead as impacted by the constraints laid upon banks' internal models, and whether banks should continue to deploy insurmountable resources to improve their internal models. Given the fundamental change of the market risk framework, banks are required to devote substantial resources to redesign their current market risk management system. It is highly recommended to allow sufficient time for the implementation. We expect the QIS to be designed constructively with a view to understanding and clarifying the requirements on a hypothetical test portfolio exercise based on the proposed trading book capital requirements. We feel that the calibration of standard rules, the capital model multiplier and model approval thresholds will have a large impact on capital requirements, and so a careful approach and thorough understanding of QIS results is required.

The paper instigates further industry discussions on models based on risk sensitivities versus a simpler standardized methodology, and over banks' risk appetite over controls and customer pricing.

Mandatory Standardized Charge Calculation and Floor

We would like to re-emphasize that the paper's introduction of a standardized approach floor will disincentivize banks to develop and fine-tune their risk models used in internal management to be more risk sensitive.

The proposed approach requires building new data feeds, new decomposition schemes and new mapping rules for cash flows and computation engines from scratch. The complexity introduced in the standardized approach may prove difficult for even larger banks – in aspects of technology investment, maintenance and data gathering.

For small and medium banks, due to lack of the data granularity, heavy system investment is required. For large banks, the maintenance of two sets of market risk systems, in long run, will deprive a bank of deploying resources more effectively and will deter development of internal models to be more risk sensitive allowing higher forecasting power for risk management.

Given both standardised-based and model-based capital charges are provided to the local regulators and disclosed publicly, it could serve the mentioned benefits without requiring to apply a standardised-based floor. We do not agree with the suggestion of a standardised-based floor as it will demotivate banks to adopt advanced modeling approach of capitalizing market risk and substantially discount modeling efforts.

We remain opposed to setting capital floors based on standard rules given the tighter model approval standards that will be applied.

Disclosures

Under the revised framework, the banks are required to disclose the following with increased frequency (per page 44):

- Explanation of drivers for change in period to period
- A more granular and consistent segmentation at desk level
- A more frequent disclosure (will be quarterly or half-yearly, instead of annually)
- Disclosure of key modeling choices
- Disclosure of key differences in models used for internal risk management and those used for regulatory capital calculations

The excess disclosure may be counter-intuitive, highly dependent on how granular the desk level information is required to be disclosed and how the changes are to be explained. Sensitive information (e.g. trading strategy, the positioning and size of trades) may easily be misinterpreted by the public.

Based on the proposed framework section 4 disclosure requirements, we understand that the BCBS is considering to increase the frequency of Market Risk disclosures from currently, annually. We would again emphasize that this will create extra regulatory burden to the banks for little value to the public interest except for the knowledge few.

Internal Models - Liquidity Horizon

One of the main criticisms so far is that the approach is not appeared sensitive to concentration. For banks, liquidity risks are normally managed at instrument level, not at risk factor level. Different instruments with the same underlying risk factor may have different level of liquidity. For example, a total return swap of a liquid underlying with a counterparty (an illiquid product) hedged with the underlying CDS have the same underlying risk factor but different liquidity. The risk factor centric approach may create disconnection between capital charge and liquidity risk management in reality. The argument in the paper for measuring liquid risk factor of an illiquid instrument can be hedged. The loss, however, is more accurately measured by shocking and pricing the illiquid instrument and its hedge separately and adding up the P&L.

Another concern is how to derive the 1-day VaR for backtesting. The backtesting is done by comparing a Bank's 1-day P&L against 1-day VaR. Under the BCBS' proposal, VaR is the measure of aggregated loss distribution of risk factors over mixed liquidity horizons. It is not clear how to derive an 1-day VaR from it. Are banks required to separately calculate a VaR with 1-day liquidity horizon for all risk factors?

We would suggest the BCBS to take into consideration of the simulation and pricing practically when introducing mixed and sometimes very long liquidity horizons into expected losses. The long liquidity horizons applied to stressed periods will result in very large shocks for these risk factors. A full-revaluation VaR ought to be developed in order to capture the full convexity of the data. Full-revaluation VaR model is costly and involved in heavy resources investment. More importantly, even

if full-revaluation VaR is implemented, and for portfolios already on full-revaluation, the mixed liquidity horizons for different risk factors imbedded in the same instruments (e.g. interest rate and credit spread risk factors in corporate bonds, equity spot and volatility risk factors in equity options) will generate un-realistic shocks to these risk factors, thus may cause breaking of the arbitrage-free conditions and correlations resulting in pricing failures. The significant effort banks need to spend day to day in maintaining smooth pricing will divert their resource from real-life risk management.

Due to the above reasons, we suggest that liquidity risk should be more appropriately captured through a separate periodic capital add-on through correlated stress tests rather than in expected shortfall. Banks would have opportunities to analyze concentrated and illiquid positions in details. Since stress tests involve only a few scenarios and concentrated and illiquid positions, the burdens for banks to heavily invest in and maintain proper pricing on a daily basis are greatly reduced, therefore can better focus on real-life liquidity risk management.

Even if mixed liquidity horizons are introduced, it is recommended to apply liquidity horizon on product, position or trading desk level considering the potential pricing inconsistency and operational difficulty of applying that on risk factor level.

Nevertheless, developing a framework incorporating liquidity is a challenge and the technical challenges imply that a phased implementation, starting with a simpler calculation is favoured and we welcome the BCBS' willingness to consider industry proposals. The simplest model would scale one day PL and the next simplest would scale one day risk factor scenarios.

We encourage the BCBS to carefully calibrate the capital model (expected shortfall multiplier) in the light of QIS results.

Moreover, the proposed liquidity horizons are too conservative. For instance, it is assumed to take 20 days to liquidate FX positions, which is not very reasonable. We would suggest the BCBS to reconsider the liquidity horizons if it is implemented.

Model-Independent Assessment Tool

The proposed model-independent assessment tool in paragraph 183(d) of the draft rule uses the ratio of market risk capital charge over the exposures measure from the leverage ratio framework to identify situations in which the amount of market risk capital charge is too small relative to the overall size of the desk. Comparing risk sensitive capital charge against an exposure measure on gross basis would not provide a representative insight on how sufficient the banks' market risk capital charge is.

As the exposure measure from leverage ratio is not model-based, it is not risk sensitive and would also fail to recognize hedging benefits. It may result in unintended consequences that trading desks tend to take on more risky positions of the same amount of exposure or leave open their risk positions instead of having them properly hedged.

On the model independent assessment tool, it requires more thought followed by testing through QIS in terms of an appropriate denominator and threshold setting.

It is not recommended to set up a minimum requirement for a bank to remain eligible for capitalization under the internal models approach as the position size of individual desks (IMA and STD desks) may change from time to time rapidly.

Trading / Banking Book boundary

The BCBS has in this consultation paper expanded the definition of trading book products. However, there are still areas of inconsistencies and uncertainty in application.

For repo and reverse repo transactions, as the underlying collaterals can be related to both trading book and banking book in the revised definition, we are in doubt as to which book should they be categorized. Are banks required to agree their repo and reverse repo activities with their regulators on a case by case basis?

Under explanatory footnote 21 in the proposed rule text, listed equity can be exempted from market risk charge subject to supervisor approval (i.e. not always under trading book). We would like to clarify if any options are entered for hedging such listed equity position, whether these options should be classified as banking book with supervisor's approval.

It clearly states the intention to exclude economic hedges to banking book liabilities (pages 7 and 8) but in Table 1, page 9 includes instruments "held for trading" under IFRS in the presumed list of covered positions. We wish to clarify whether the hedge accounting proposed in the revised accounting standards on cash flow hedges and fair value hedges can still be treated as banking book under the proposed market risk framework. Hedged instruments may not necessarily be classified as trading book items under accounting rules. Please clarify whether the terms "Instrument" and "Instrument Type" are interchangeable. If a bank holds two IRS, can the bank classify one to Trading Book and one to Banking Book? Or does the bank have to classify all IRS to only one book? Should the supervisory exemption approval be on "Instrument", "Instrument Type" or "Transaction" level?

The Basel working group has indicated a common sense approach and this is welcomed e.g. retail products such as mortgages may contain an implied embedded option, but should not be classified as "options" for the purposes of the boundary. Please specify the definition of "option". Is the embedded option in an instrument a type of "option"? Are prepayment options in certain loans classified as "option" in this context? Also, does it mean any option is required to be assigned to trading book even though the option is not an accounting trading asset or liability?

The trading book presumption list includes the instrument resulting from underwriting activities. Does it mean instruments since the initial subscription of the underwriting program will be assigned to trading book if the exemption is not granted by the regulator?

Revised Standard Approach

The move to more risk sensitive standard rules is welcomed but we note the very significant development of systems and processes in order to collect and validate cashflows. We favour leveraging existing validation and control processes for sensitivities (PV01 and CS01) in the interests of helping the BCBS achieve quicker implementation. We recommend assigning the strict non-discounted cashflows to the vertices. Using discounted cashflows would not enhance the “accuracy” much but adding operational difficulties to banks. For instance, to calculate the foreign exchange exposure, banks are required to build a discount curve to discount the foreign currency cashflows and allocate the discounted cashflows to different buckets. Apparently, banks are required to discount all cash flows of assets and liabilities positions (including loans and customer deposits) and heavy system investment is needed but without benefit. Same case applies to the calculation of the GIRR. Also, the shifts in volatility depend on the sign of vega; correlations depend on the sign of exposure, etc. These are difficult to implement and with little benefit. It is suggested to use a simpler implementation.

Some parameters adopted are too conservative. For instance, the FX rate risk is subject to standard 15% capital charge with correlation parameter at 60%. When a local currency is pegged against another currency, the market risk of FX for currency exposure on the pegged currency should be lower than that of non-pegged currency and the pegged currencies are more correlated. We would suggest the BCBS to differentiate the pegged and un-pegged currencies to better reflect the risk sensitivity and the FX depeg risk should be separately capitalized. Moreover, on the classification of equity markets, given the Hong Kong equity market is well-developed, it is recommended to include Hong Kong to the list of developed markets. We suggest adopting the MSCI classification of developed and emerging markets.

Internal Models - Credit

Constant Level of Risk

Under this proposal, Incremental Risk Charge (“IRC”) will revert into Incremental Default Risk Charge (“IDRC”). On page 15 under Liquidation approach, the BCBS mentioned that “this is a departure from the current requirements under the IRC, which requires banks to calculate capital using a constant level of risk over a one-year capital horizon” i.e. banks will re-invest in a similar quality bond following a default.

Referring to the rule text para 186 (e) under the Default Risk section, “A bank must assume constant positions over the one year horizon.” It does not specifically mention the requirement of “using Constant level of Risk”. As such we would like to seek the BCBS’ clarification on whether it means the requirement of using “Constant level of Risk” will be removed.

Incorporating Equity Positions in IDRC

Generally, we welcome the proposal to standardize modeled default risk, recognize that migration risk is better captured through longer horizon spread volatility, clarify some model details (number of systematic factors, correlation calibration), and re-introduce IDRC to remove the double counting impact on credit rating migration risk and its extended application to equity exposures for default loss.

Although it is reasonable to include default loss on equity positions in IDRC, given the short liquidity horizons of equity shares, we believe the 3-month floor on liquidity horizon is not reasonable. In fact, equity price liquidity horizons specified in table 2 on page 16 are only 10 days for large cap and 20 days for small cap. We suggest the BCBS to change into the shorter liquidity horizons specified in the risk factors table for consistency.

In addition, the “constant level of risk”, currently applying to the debt instruments, is also overtly punitive for equity positions. Thus, we urge that it should be removed if equity position is to be reflected in IDRC going forward.

Default risk in Internal Model

Paragraph 186(f) of the draft rule requires that the probabilities of default (PDs) of obligor are subject to floor of 0.03%. In internal rating based approach for credit risk, the floor on PD is only applicable to corporate and bank exposures. Sovereign exposures are exempted from the floor on PDs. Applying floor on sovereign exposures for market risk would result in inconsistent measurement of default risk between trading book and banking book and create opportunities for capital arbitrage. Moreover, it does not align to the general principle for bringing trading book requirements closer to credit risk of the banking book.

Trading Desks

Some banks believe the desk level regulatory approach puts a huge burden on banks' operation and induces high implementation costs but with little value in improving risk management. While, other banks welcome the desk-based approach as best practice and note that the extra requirement of PL attribution will provide a good test of models, revealing missing basis risks at a granular level but would recommend that thresholds be set in the light of QIS results and should recognize unintended consequences of type I errors (desks falling in and out of approval).

The proposed capital penalty for under-performing models remains multiplier based and a transition approach at the desk level (fraction of standard rules surcharge) is favoured.

Upon the definition of trading desk, we would like to have the clarifications on:

- 1) definition of “Trading Accounts”;
- 2) it is required the desk must have a Head Trader: Can a desk have more than one Head Trader? Can a trading desk have only one person taking the role of both trader and Head Trader? For a Head Trader without trader's role, can he be

- assigned to be the Head Trader of more than one trading desk?; and
- 3) For the Head Trader, his role may cut across several businesses. Please define “businesses”. Is the banking book treasury activity a type of such businesses? For a trader being assigned to a trading desk, can he conduct banking book treasury activities?

Given the new framework is based on Trading Desk and IMA is approved on Trading Desk level, it is recommended to define IMCC(Ci) as the expected shortfall charge of each IMA Trading Desk (rather than risk factor) to align with the internal risk management.

Other questions and clarification needed

Page	Quotation	Questions/Clarification needed
9	Daily MTM requirement	<p>Is the proposed daily MTM standard the same as the accounting standard? For the back-to-back transactions (normally complex products), the bank has no residual market risk, but the accounting standard requires both the Long and Short positions of the back-to-back transactions be marked. Most of the time, the source is not available daily. For risk management perspective, is the bank allowed to mark the Long and Short positions of the back-to-back transactions as a portfolio?</p> <p>For an instrument that the bank is unable to mark daily, is the instrument eligible to be in trading book?</p>
24	Flow chart	<p>We would like to seek clarification from the BCBS that the bottom of right most box “capital add-on based on stress scenario per risk factor” mentioned in the “Process for determining the eligibility of trading activities for the internal models-based approach” under Figure 1 on page 24 refers to the same existing “Risks Not in VaR” capital add-on.</p>
27	Falling back Period for Failure in 3 Supervisory Assessment Tools	<p>Based on the proposed framework, banks are required to have on-going monitoring and reassessment through 3 assessment tools to justify whether a trading desk can still be eligible for capitalized under internal models approach (described in page 27). The 3 assessment tools are namely 1) P&L attribution, 2) backtesting assessment and 3) model-independent assessment tool. Any failure of either one assessment will require such trading desk to immediately switch into standardized approach. Though there is no explicit mentioning of falling back period, our interpretation is at a minimum one-year, which is the required data</p>

		<p>observable period for a single risk factor under internal model approach. We would like to seek the BCBS' confirmation.</p> <p>Assuming it is affirmative to the interpretation that the fall back period being set at a minimum of 1 year, this will disincentivise the industry to offer new products for risk mitigation as any new products would require 1 year of historic data to be available.</p>
49	Paragraph 14: Banks must fair-value daily any covered instrument and recognise any valuation change in the profit and loss (P&L) account.	<p>Does "recognise any valuation change in the profit and loss (P&L) account" mean the bank must post the daily P&L into the general ledger system on daily basis?</p> <p>Does the money market instruments (i.e. placement/acceptance) in the trading book must be fair-valued through the P&L on a daily basis?</p>
51	Inventory ageing reports	<p>While "inventory ageing report" may reflect the liquidity risk of trading book instrument, from time to time, for cash instruments, same issue may be in and out frequently, for example, active trading government bond. Usually average cost method is applied to measure market risk of trading portfolio. Without the implementation of LIFO, FIFO, it is not easy to construct a meaningful ageing report. For derivatives, in Hong Kong, banks seldom unwind individual transaction but usually hedge the position. Almost all the outstanding derivative transactions are in the inventory report. Risk information may not be able to retrieve and interpret correctly.</p>
56	Section B: The capital requirement 1. Definition of capital	<p>The definition of capital under the revised market risk framework is defined with reference to Basel II framework which is no longer valid with Basel III being implemented currently. Please rectify.</p>
59	Treatment of Convertible Bonds	<p>According to paragraph 70 of the draft rule, convertible bonds should be treated as positions in equity with the following treatment:</p> <p>"an addition equal to the current value of any loss that would arise if the convertible bond did convert to equity"</p> <p>A convertible bond usually remains in debt form</p>

		when the underlying equity price is below the conversion price (as the embedded equity option is out of the money). In such scenario, the convertible bond holder should be subject to credit risk of the convertible bond issuer, instead of equity risk. The proposed treatment does not seem to be accurately reflecting the economics of a convertible bond.
72	Where “large” is defined as a market capitalization equal to or greater than \$2 billion and “small” is defined as a market capitalization of less than \$2 billion.	When calculating the market capitalization, 1) is free-float adjustment considered? 2) what is the treatment of the stocks with A-shares listed in Shanghai/Shenzhen and H-shares listed in Hong Kong?
86	Paragraph 181 (d): The identified reduced set of risk factors must be able to explain a minimum of [75%] of the variation in of the full ES model.	Please specify the definition of “the variation in of the full ES model”. Could banks use incremental ES to evaluate the percentage of variation of the missing risk factors?
86	Paragraph 181 (d): $\frac{ES_{F,C}}{ES_{R,C}}$	Does BIS require banks to update the factor of $\frac{ES_{F,C}}{ES_{R,C}}$ on daily basis? Can this factor allow to be smaller than 1?
86	Footnote 36: $P\&L_{t-x+1;t-x+11}$ is added to $P\&L_{t-x+2;t-x+252}$;	Should it be “ $P\&L_{t-x+1;t-x+11}$ is added to $P\&L_{t-x+1;t-x+251}$ ”?
87	Paragraph 181(f): The observation horizon for determining the most stressful 12 months must, at a minimum, span back to 2005.	Paragraph 181(f): The requirement on spanning the historical observation horizon back to 2005 is inconsistent with the 10 years minimum observation history in paragraph 181(d). Given some supervisors may request a stress period up to 1997 (e.g. HKMA), to align a level-playing field and reduce model inconsistency, it is suggested to rephrase the requirement to “181(d)... have an observation history of [10] years.....” and “181(f)...

		The observation horizon for determining the most stressful 12 months must span back [10] years”.
87	<p>Paragraph 181(j):</p> <p>Each bank must meet, on a daily basis, a capital requirement expressed as the sum of the higher of (1) its previous day’s aggregate capital charge for market risk according to the parameters specified in this section (ACC_{t-1}); and (2) an average of the daily capital measures in the preceding 60 business days (ACC_{avg}).</p>	<p>Is it a requirement that a bank must calculate standardised-based capital charge on daily basis?</p>
87	Table	<p>Please elaborate the definition of Interest Rate (other), Equity (other), FX (other), Credit (other) and Commodity (other).</p> <p>The table in page 87 is not consistent with Table 2 in page 16. In page 87, only Interest Rate Volatility is specified at “ATM (at the money)” whereas all volatilities in Table 2 are specified as ATM volatility. It is believed that banks are difficult to implement different liquidity horizons for different node points of volatility (ATM node and non-ATM node), it is recommended not to specify ATM volatility as a board category.</p> <p>Even BIS intended to define ATM volatility as a board category, since there are several definitions on ATM volatility (e.g. same strike, $\delta = 0.5$), it is recommended to specify the definition of ATM volatility.</p> <p>Should the bank apply the FX liquidity horizon for Gold?</p>

89	Paragraph 183(b): Backtesting requirements are based on comparing each desk's 1-day static value-at-risk measure at both the 97.5th percentile and the 99th percentile, using at least one year of current observations of the desk's one-day P&L.	<p>Does the "one-day P&L" mean the one day actual and theoretical P&L?</p> <p>We would like to clarify if any given desk fails in one of the four back-testings (backtesting the one day actual P&L on 97.5th percentile and 99th percentile as well as backtesting the one day theoretical P&L on 97.5th percentile and 99th percentile), the desk must be capitalized using the standardised approach.</p> <p>Is the definition of one day actual P&L and theoretical P&L used in back testing same as that definition in P&L attribution analysis?</p>
90	Paragraph 183(c): For a risk factor to be classified as modellable by a bank, there must be continuously available "real" prices for a sufficient set of representative transactions.	<p>Should proxy data consider as modellable risk factor?</p> <p>Given the financial innovation of RMB products, historical data is generally unavailable for such products and proxy data is used. It is recommended to consider proxy data as modellable risk factor.</p>
92	Paragraph 185(c): For exchange rates (which may include gold), ...	<p>Given gold is grouped into commodity risk under standardised approach, does gold should be grouped into commodity risk under IMA approach? Is it the bank's discretion to decide the grouping of risk factors under IMA approach?</p>
93	Paragraph 186(b): The VaR calculation must be done weekly and be based on a one-year time horizon at a one-tail, 99.9th percentile confidence level.	<p>Similar to expected shortfall, does the PDs in VaR need to be based on a period of stress?</p>
94	Paragraph 186(r): Due to the unique relationship between credit spread and default risk, banks must seek approval for	<p>For a bond trading desk, can a bank apply IMA for general interest rate risk only and use standardised approach for credit spread and default risk?</p> <p>For an equity trading desk, must banks seek approval for both market risk model (i.e. ES) and default risk model (i.e. IDR) in order to apply IMA?</p>

	each desk with exposure to these risks, both for credit spread risk and default risk. Desks which do not receive approval will be deemed ineligible for internal modelling standards and be subject to the standardised capital framework.	
95	Paragraph 189: The plus will range from 0 to 1 based on the outcome of the backtesting of the bank's daily VaR at the 99th percentile based on current observations on the full set of risk factors (VaR _{FC}).	Given ES had replaced VaR in the capital framework, the plus factor should be relied on the backtesting results of ES at the 97.5 th percentile instead of VaR. It is recommended to establish a backtesting framework for ES.
95	Paragraph 190: For each non-modellable risk factor, the liquidity horizon of the stress scenario should be the greater of the largest time interval between two consecutive price observations over the prior year and the liquidity horizon assigned to the risk factor in paragraph 181.	Does it mean the bank should review the liquidity horizon of non-modellable risk factor on annual basis and calculate SES on daily basis?
79	Weighting term (WtS) in default risk	Weighting term proposed in paragraph 151 of the draft rule is used for limiting the offsetting effect by short position in default risk. The weighting term is calculated by dividing the jump-to-default (JTD) for all long positions by the total of JTD of both long and short positions. Paragraph 147 of the

		<p>draft rule requires that the JTD value is derived by multiplying Loss Risk Weights with the notional minus the MTM loss taken on the exposure.</p> <p>We consider that the JTD would be overstated for instruments with optionality features. The correct risk measure on option products should be delta equivalent value, instead of notional, to cater for the at-the-money and out-of-the-money scenarios. The delta equivalent value concept is also being proposed in paragraph 164 of the draft rule under “Options non-delta risk” section. We urge for consistency under the whole market risk framework.</p>
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