ISP response to the BCBS consultative paper

Fundamental review of the trading book: A revised market risk framework

January 2014

1 Introduction

We welcome the possibility to comment the Consultation Paper on Fundamental Review of Trading Book (FRTB). Although we appreciate the effort made in the definition of a more coherent framework for capital requirement, which avoids double counting and improves some of the weaknesses characterizing the current framework (Basel 2.5), we seize the opportunity to address our concerns of what we think are major “fatal flaws”.

2 General Framework

The implementation of the proposed framework pose a huge challenge from risk management and operational point of view.

First of all, it requires risks to be valued by using two different methodologies, one for the risk management of the books and one for the calculation of capital requirement which would differ sensibly from each other. Stressed Expected Shortfall features might be suitable for tail risk comprehension but will always be ancillary to current VaR measurement in the day by day risk management activities. The main risk is that business activities will not take this measure into account.

From a risk management perspective, we are therefore concerned with the uncertainty deriving from the gap between the two measures as it would impact unpredictably on the capital consumption of the trading book.

From an operational viewpoint, this translates into a dramatic increase in IT developments and in a substantial reduction of reporting synergies implicit in aligned risk measures.

The FRTB implies:

- burdensome amount of information that financial institutions should provide
- complex system of approval processes binding the business activity of the bank
- time consuming administrative activities

We think that the implementation of the FRTB lacks of an efficient risk management approach and contrasts with the dynamic nature of the financial industry. We strongly believe that the regulatory reporting and approval frameworks of the FRTB should be simplified by introducing simple notification procedures.

We found challenging the proposed timetable for the implementation of the FRTB prescriptions and of the QIS to calibrate the framework. We welcome the two steps process for the QIS, starting with a test portfolio followed by a test on the entire portfolio; we think however that adequate timeframe should be allowed for the industry to elaborate results that can provide an accurate and meaningful impact of the new rules.

Given the amount of required changes, the testing of both the sample and actual portfolios implies a complicated set-up as it requires structural changes in model parameterization and results aggregation. Given the amount of parameters involved in IMA e SA calibration (more than 50), a second round of QIS will be needed in order to achieve a comprehensive assessment of the final framework

Even if a policy document cannot be mixed with a technical standard, further disclosure should be provided for the phasing in process.

Further, process innovation should be taken into account in the timetable definition: the new SA monitoring is relevant both in terms of measurement and in terms of resources.

3 Trading book boundary

Although it is clear that liquid, traded and hedgeable asset classes should be in the trading book, we highlight the following issues which have an impact on the business activity.

First, we expect that the same asset class will be allowed to be booked in different regulatory books. Given these premises, we would like to highlight the following alert points, if our expectations were disregarded:

- Binding asset classes either in the banking or in the trading book will have as a collateral damage the decrease in the trading activity performed by regulated institutions.
- Banks could no more intermediate the issuer and final investors (insurance company, pension funds etc.). As a consequence, banks could no more play a fundamental role in the stabilization of financial markets.
- Not only Governments, but also corporates and financial institutions will experience funding issues with consequences on the economy as a whole. The intermediary function will be increasingly performed by shadow banking.

- Furthermore, we believe that asset classes held for liquidity purposes (i.e. LCR's liquidity buffers) and/or for regulatory constraints should be excluded from the trading book

- Instruments hedging items classified in the banking book should be classified in the same book, even if they can't be accounted as hedging instruments due to limitations of the accounting standard. If the hedging instrument and the hedged item were treated differently, the prudential view will show an open risk position where there is no economic risk

The FRTB prescribes that if an authorized booking reclassification will generate capital benefits, the capital requirement for that position will always be the higher between the two booking frameworks.
We believe that this constraint can be extremely penalizing for financial institutions and strongly reduces the benefits and synergies that can be reached through consolidated trading expertise. Moreover, we suggest considering the possibility to include illiquid assets within the trading book through, for example, stress test based requirements in order to allow an efficient risk management of these instruments.

4 Standard Approach

As for the SA approach, we welcome the possibility to define it as a credible fallback for internal model. However, we do not believe that the proposed new cashflow approach is suitable for this purpose.
A sensitivity based approach, though it introduces a model dependence in the first Pillar, is far long preferable. The drawbacks related to this are strongly mitigated by the existence of a shared knowledge on greeks measurement which makes the TBG proposal of a costly, unknown, and currently incomplete (see floating cashflow management) less preferred.

5 IRC and IDR

We appreciate the effort made to eliminate double counting regarding migration risk by moving from the IRC to the IDR requirement; however, we highlight the following points:

1. Inclusion of equity: while double counting is now reduced for credit spread related products a potential issue will be introduced with the equity inclusion in the IDR. Additionally, in order to guarantee a coherent approach between trading and banking book, we suggest that the trading book requirement should allow for the possibility of being reduced to a three month liquidity horizon (similarly to the banking book)
2. Further disclosure should be available for correlation estimates between recovery and systemic risk factors.

6 Liquidity horizon

The way liquidity horizons have been fixed in the document is not transparent and sometimes goes against empirical evidence.

For instance, foreign exchange has been given a longer liquidity horizon than equity cash. Moreover, there is no historical track record of the illiquidity of sovereign bonds related to their rating.

We expect some surprises and inconsistencies will arise from the proposed application of joined simulation of different horizons.

Overlapping returns and the implied autocorrelations are against any sound econometric application of inferential statistic. These provisions do not break correlations, they simply induce erratic forecast of the models and, by chance, might not result in more conservative measures.

Moreover, this method does not take into account correctly the risk associated with path dependent instruments or with those instruments expiring before the end of the liquidity horizon.

Finally, since the theoretical models are back-tested only over daily horizons, their outputs over longer horizon can result in a capital charge measure that is not representative of the true risk of the portfolio.

We strongly support a simpler approach in which liquidity horizon can be applied ex post to the one day simulation. Whatever the applied liquidity horizon will be, a minor violation of simple econometric and arbitrage condition will be granted.

Finally, this approach might support a simpler use test without excluding the impact of liquidity on the final requirement.

CVA charge for IMM banks the Advanced Approach will be based on bank's ES model to calculate the capital charge for bond credit spreads: will the regulatory longer liquidity horizon apply to CVA? Impact on capital charge could be very high on a component of capital requirement which is already very conservative: we ask for clarification on this point both in terms of liquidity horizon to be applied and in terms of multiplier for CVA VaR.

7 Internal model

Given the complexity of the new framework, the target level for the new capital requirement should be clarified. The current level of capital requirement has proved to be very conservative for IMM banks within Basel 2.5 framework).

Higher level of capital requirements would result in a punitive measure; an incentive to the IMA has to be maintained with respect to the SA approach, taking into account the efforts of IMA Banks in developing sound models and high risk culture.

Eventually, the SA based floor might limit but not exclude the IMA approach capital relief. The same holds for the model-independent-assessment tool. If the requirement calibrated on the stressed period by chance favors a single regulatory desk with the attribution of a reduced requirement (given that the P&L attribution works for the same desk) it wouldn't be fair to switch it to the SA approach.

The proposed model independent risk tool might not achieve the goal of identifying desks with complex, potentially illiquid instrument that carry higher model risk. Low risk density is not necessarily an indication of modelling problems. Furthermore, the model independent threatens desks with low risk profile implying the adoption of the revised Standardized Approach.

We welcome the use of theoretical P&L for the computation of VaR breaches, once the P&L attribution process has been completed successfully. We argue that a pragmatic and flexible approach should be endorsed to the Supervisor for the explanation of poor results especially because liquidity issue may deteriorate statistics even if a good theoretical model is in place.

Generally, the P&L attribution increases regulatory capital volatility during market turmoil. As a consequence, the gap between actual and theoretical P&L may differ and induce the failure of the test that should not penalize the whole IMA adoption.

As for ρ determination we do not agree with the generic multiplier. Specific model performance test should be performed in order to calibrate individually the coefficient. The stressed Expected Shortfall allows regulators for a general correlation reduction. A generic ρ can generate asymmetric shocks on different institutions capital requirements and reduce the homogeneity of RWA: the opposite of the TBG goal.

8 Disclosure

The effects of risk measure disclosure at desk level to the market would have disruptive effects on trading activities.
We think that it would be more appropriate to limit to Regulators the provision of a more complete and granular set of information.
Overall we think that the degree of information already provided to the public should not be increased.