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Basel Committee on Banking Supervision
Bank for International Settlements
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Second Consultative Document - Fundamental review of the trading book: A revised market risk framework – BCBS 265¹

Dear Ms. Barger and Mr. Adkins,

This letter contains the response of Nomura Holdings, Inc. ("Nomura") to the Basel Committee on Banking Supervision ("BCBS") Second Consultative Document *Fundamental Review of the Trading Book: A revised market risk framework* dated October 2013 ("Fundamental Review" or "FRTB").

Nomura is pleased to have the opportunity to comment on the Second Consultative Document.

We hope to continue this productive dialogue and are committed to support the TBG's efforts of refining the FRTB proposals.

Yours sincerely,

Eduardo Epperlein

Global Head of Risk Methodology

Nomura

cc: Japan Financial Services Agency

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¹ Basel Committee on Banking Supervision, October 2013 – BCBS 265

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1. Executive Summary

Nomura welcomes the opportunity to comment on FRTB. In general we are supportive of the Trade Associations' feedback to the TBG on this matter, and in particular would like to draw the committee's attention to the letters sent on January 3, 2014 and January 19, 2014, reflecting the outcome of extensive industry deliberations on various technical aspects of the Fundamental Review. We also share the concerns which have been expressed to the TBG in the Trade Associations' letter of January 8, 2014 around the proposed timeline for implementation of the QIS. Given the truly fundamental nature of some of the proposed revisions, we believe the proposed timeline to be insufficient, and would strongly recommend that this be extended, to enable careful examination of all technical issues, and thorough testing of the impact of the proposed rules.

There are certain specific areas where we would like to take the opportunity to comment further, namely:

- Treatment of Liquidity Risk
- Treatment of Securitizations
- Inherent Limitation of P&L Attribution Analysis
- Explicit Capture of Basis Risk in the Revised Standardized Model

2. Treatment of Liquidity Risk

Nomura supports the comments on Liquidity Risk made in the letter from the trade associations to the TBG on January 19, 2014 [1] but would like to take this opportunity to make some further comments around the technical details of incorporating liquidity risk into capital, drawing on our firm's experience of running a liquidity-adjusted model for Economic Capital for the last two years.

2.1 Issues with Proposed Approach

As described in [1], we share the overarching concern of the industry about the proposal (see [2]) to capture liquidity risk by directly applying long-horizon market shocks of differing duration to compute portfolio P&L. The main drawback of this proposal is applying market shocks of different duration may 'wash away' the empirically observed correlation which is observed between risk factors, especially in a stressed market. In Figure 1 below², for example, we show the observed correlation between changes in the CDX index of IG credit spreads and returns on the S&P 500 equity index. Where a consistent time horizon of 10 days is used for both (i.e. the same shock period as specified in Basel 2.5 for VaR and SVaR), we can see that the correlation is materially negative, as one would expect, and is reasonably stable. On the other hand, when we compute the same correlation but using 60 day changes in the CDX and 10 day returns on the S&P 500 (i.e. the horizons proposed in [2]), the result is much smaller and more volatile. Thus a bank with a concentration of exposures across these risk factors could see 'too much' diversification, and also see large swings in capital depending on the exact period chosen to calibrate Stressed ES.

[1] Letter from ISDA, GFMA & IFF to Trading Book Group regarding 'Second Consultative Document Fundamental Review of the Trading Book', January 19, 2014.

[2] Basel Committee on Banking Supervision, 'Second Consultative Document Fundamental Review of the Trading Book', October 2013.

² All data and calculations are available on request.

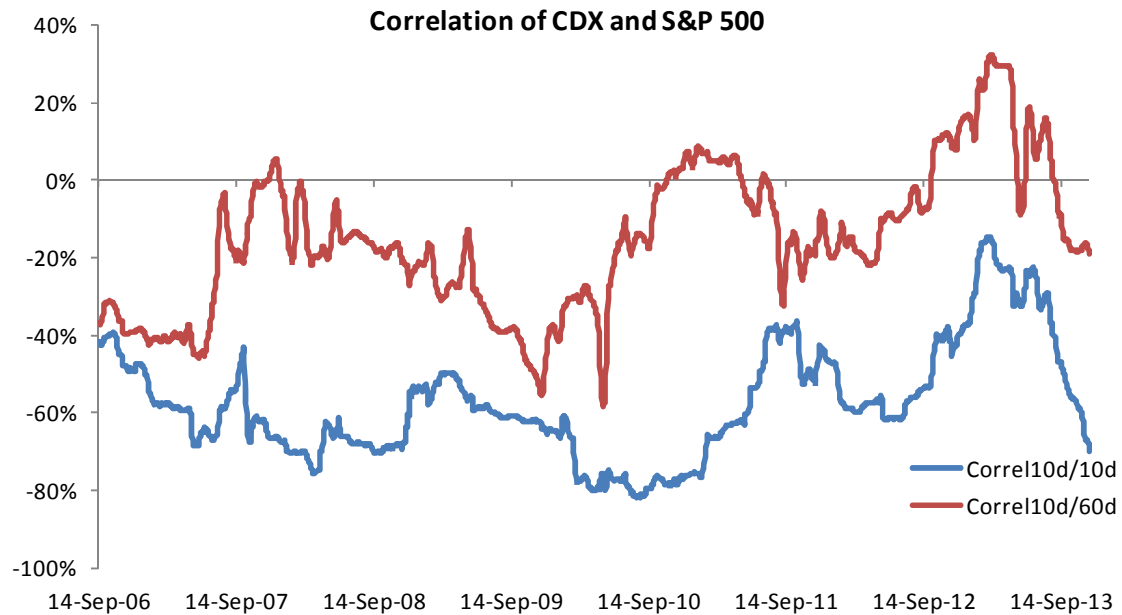


Figure 1 - one year rolling correlation between CDX changes and S&P 500 returns, comparing consistent 10-day horizons with 60-day horizon for CDX and 10-day for S&P 500

Another potential issue with the use of long horizon shocks directly is that for illiquid risk factors (e.g. HY credit spreads, with a 120 day horizon), the effective sample size to be used in the capital calculation (based on one year of stressed market data) becomes very small, which may result in a very volatile result.

Finally, using long horizon market shocks may create a practical challenge with re-pricing trades under a shocked market which may be very far from the current market and hence contain arbitrage opportunities. While firms already have to deal with such an issue when stress testing their market risk portfolio, this is mitigated by the fact that stress scenarios tend to be carefully designed to be realistic, rather than simply driven by market data directly. Moreover, stress scenarios would generally be specified over a single time horizon, whereas under [2] different risk factors would be shocked over different horizons, significantly increasing the likelihood of 'infeasible' market scenarios being generated.

2.2 Potential Alternative

As described in [1], in order to tackle the above issues the industry consensus is that a better approach is to compute P&L over a single time horizon – preserving empirically observed correlation between risk types – and then adjust this for liquidity. As this is an emerging area of risk measurement, there is no consensus in the industry on how exactly this adjustment can best be implemented, and hence a range of approaches were described in the industry response. Nomura's view is that the third approach described in [1] offers the best way to adjust for liquidity in a risk sensitive way, as follows.

The first step is to simulate PnL over all desks over a single liquidity horizon, to resolve the correlation problem described above. We propose the use of a 10-day³ horizon, for the following reasons:

³ If the TBG prefer, another horizon (such as 20 days) could be used instead. The key is to avoid having too short a horizon to capture correlations properly, while not having such a long horizon that the sample size becomes insufficient.

- Using a shorter (e.g. 1-day) horizon is likely to lead to underestimation of correlations where risk factors are typically measured at different times of day. As shown in Figure 2, for example, the correlation of 1-day returns between the Nikkei 225 and the S&P 500 equity indexes is generally small, whereas using 10-day returns leads to much higher correlation, particularly under stressed conditions. Also, using such a short horizon would lead to relatively small market shocks being applied to compute PnL, and hence limit the level of convexity captured by the model.
- Using a much longer (e.g. 60-day) horizon is theoretically appealing, as it would pick up a high degree of portfolio convexity, and fully reflect long horizon correlations. However, we believe that these advantages would be outweighed by the serious practical problems associated with applying long horizon market shocks – very small effective sample size (note how the 60-day correlations in Figure 2 are more volatile than the 10-day), and unrealistic market scenarios creating impossible-to-price outcomes in the model. This would also mean that we need to somehow scale down the P&L for risk factors with horizon much less than 60-days.
- The use of a 10-day horizon would be consistent with the standard already in force under Basel 2.5 (where both VaR and SVaR are computed using 10-day shocks), enabling quicker implementation of this part of the Fundamental Review, and covering some degree of portfolio convexity. It also coincides with the shortest liquidity horizon (for large cap equities) specified in [2], thus no risk factor would need scaling to a shorter horizon.

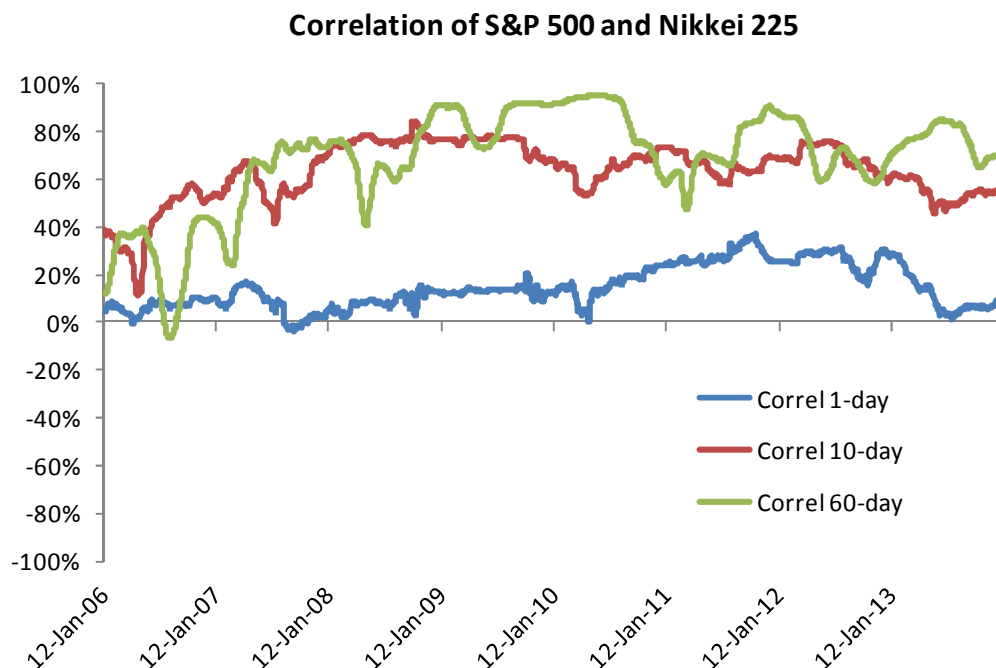


Figure 2 - one year rolling correlation between Nikkei 225 and S&P 500 returns

Given PnL computed over a single horizon, the next step is to derive a liquidity horizon for each desk. Following the regulatory thinking⁴, this could be done on a risk factor basis, by looking at which risk factors drive the risk on each desk, as follows:

1. Allocate each risk factor to a liquidity horizon, as outlined in the Fundamental Review proposal

⁴ For Economic Capital, Nomura uses desk liquidity horizons based on Risk Manager judgement, subject to certain guidelines. While this works well for EC, we recognise that such a high degree of expert judgement may not be appropriate for regulatory capital.

2. For each desk in the market risk capital calculation, compute the Stressed ES by risk factor
3. Based on this, compute the weighted average liquidity horizon for this desk

Given the desk-level liquidity horizon, the last step is to adjust the 10-day P&L by desk, and combine to generate the firm level loss distribution and capital requirement. The adjustment factor is computed as the square-root of the ratio of the desk level liquidity horizon to the horizon used to compute the base PnL, for example ten days. Finally, the scaled PnL vectors are summed to generate the firm level liquidity adjusted P&L, which can be used to determine the capital requirement.

One may ask why we don't simply take the P&L by risk factor computed in step 2, and adjust each of these according the liquidity horizon for that factor, eliminating the need for a desk-level horizon altogether. The reason is that, wherever a firm is using full re-pricing (as opposed to risk factor sensitivities) to compute market risk capital, there will always be some risk which results from co-movements in multiple risk factors, and hence cannot be ascribed to a single risk factor type. If we simply used risk-factor based P&L to compute capital, this risk would be omitted completely, and hence we recommend a desk based approach. Also, we believe this fits well with the Fundamental Review package overall, as 'desk' is already the primary dimension along which risk will be measured and capitalized (see [2], section 2.2).

2.3 Worked Example

To illustrate our proposal, suppose that a firm has just three Trading Desks in scope for model approval: Exotic Rates, Flow Credit and Cash Equity. We begin by computing the standalone ES by risk factor for each desk, as shown in Figure 3. Then, using the risk-factor based liquidity horizons we derive a weighted average liquidity horizon for each desk: we can see that the Flow Credit desk, which is mainly exposed to relatively illiquid credit instruments gets fairly long horizon of 53.8 days, whereas the Cash Equity desk, which is mainly exposed to liquid equity risk, gets a much shorter horizon of 15.5 days, with the Rates desk in between.

Horizons from FRTB

Risk Factor Category	Liquidity Horizon (days)	Desk Level 10-day ES			Factor Level Liquidity Scaling		
		Exotic Rates	Flow Credit	Cash EQ	Exotic Rates	Flow Credit	Cash EQ
IR	20	\$40	\$10		31%	8%	
IR ATM vol	60	\$50			38%		
IR (other)	60	\$20			15%		
CR - sov (IG)	20		\$30			23%	
CR - sov (HY)	60		\$20			15%	
CR - corp (IG)	60		\$40			31%	
CR - corp (HY)	120		\$20			15%	
EQ (large cap)	10			\$50			45%
EQ (small cap)	20			\$50			45%
FX	20	\$10	\$10	\$10	8%	8%	9%
FX ATM vol	60	\$10			8%		
Desk Liquidity Horizon:		44.6	53.8	15.5			

% risk drivers by desk

Weighted average of factor-level horizons

Figure 3 - deriving desk level liquidity horizons, worked example

Next, we derive the desk level scaling factor by desk, by taking the square root of the ratio of desk level horizons to the 10-day baseline used to compute losses, see Figure 4.

Desk Liquidity Horizon:	44.6	53.8	15.5	$= \text{sqrt}(\text{LH})/\text{sqrt}(10)$	Multiply 10-day P&L by desk scaling factors		
DeskScaling Factor:	2.11	2.32	1.24				
Scenario	10-day P&L			Scaled P&L			
	Exotic Rates	Flow Credit	Cash EQ	Exotic Rates	Flow Credit	Cash EQ	Total
1	\$14.2	-\$39.2	-\$16.1	\$30.1	-\$91.0	-\$20.0	-\$81.0
2	-\$41.9	\$1.9	-\$31.9	-\$88.4	\$4.4	-\$39.7	-\$123.7
3	-\$2.7	-\$12.2	-\$33.5	-\$5.8	-\$28.2	-\$41.6	-\$75.6
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
⋮	⋮	⋮	⋮	⋮	⋮	⋮	⋮
9999	-\$10.6	-\$15.3	\$29.2	-\$22.4	-\$35.4	\$36.4	-\$21.5
10000	-\$36.9	-\$11.4	\$59.8	-\$78.0	-\$26.4	\$74.4	-\$30.0

Set capital as ES of Total P&L, post liquidity adjustment

Figure 4 - computing liquidity adjusted P&L by desk, and aggregating to total liquidity adjust P&L, worked example

Given this, we scale the 10-day PnL vectors (from all risk factors) up to form liquidity adjusted set of PnL for each desk. Note that the correlation between desks is automatically preserved, since for any values of LH, we know that

$$\text{corr}[P\&L_1, P\&L_2] = \text{corr}[\sqrt{LH_1} \times P\&L_1, \sqrt{LH_2} \times P\&L_2]$$

Finally, the liquidity adjusted desk P&L vectors are aggregated to find the total liquidity adjusted P&L for approved desks, which flows into the capital calculation.

3. Treatment of Securitizations

Nomura appreciates the opportunity to respond to the Committee and we recognize the many challenges in developing a comprehensive framework with respect to trading book treatment for securitized products. At the same time, we believe it is critically important that the framework:

1. Allow for fair competitive environment for banks across the globe,
2. Allows where appropriate for implementation of risk based tools reflecting the depth of loan level performance data, and
3. Does not create a regulatory arbitrage for banking book treatment versus trading book treatment.

3.1 Trading Book/Banking Book Alignment

Nomura fully supports the Committee's objectives to align the trading book treatment of securitized products capital charges with the treatment of banking book approaches as it relates to securitization. Failure to do this would create arbitrage opportunities for market participants to encourage banking book treatment of products. It would also directly benefit commercial banks that operate with large static banking books, to the relative disadvantage of market makers that provide important sector liquidity. This disparity would exist, even though banking book and trading book participants have access to similar granular data with respect to outstanding positions. (As the Committee considers the appropriate trading book application, it is important to note the depth of trading sector liquidity. In 2013, trading volume in US non-agency securitized products exceeded \$1.2 trillion (as reported in Finra TRACE)). These volumes reflect trading activity with thousands of counterparties, including money managers, insurance companies, and banks.

Both banking book and trading book investors in the US securitized products market have access to a very highly level of collateral performance information with respect to securitization assets. For

example, with respect to US Non-Agency residential mortgage backed securities investors have access to loan level data with respect to 95% of the RMBS secondary market. This loan level data covers 25 million individual mortgage loans, reflecting more than \$5 trillion in mortgage loan balances. The loan level data, which is updated monthly, typically includes 150+ data fields. These data fields include, payment history (for the life of the loan), collateral valuation (original and updates), credit scores (original and updates), and loan to value (original and updates).

This granular portfolio information is updated monthly and stratified by loan type and geographic region. The scope of this granular information (life of loan), and the frequency of updating (monthly) compares favorably with the mortgage loan performance information that would be held by commercial banks with respect to banking book portfolios of whole loans owned by commercial banks. And this information allows investing firms to perform more accurate assessments of the credit risk associated with securitized products that is sophisticated and granular.

The current banking book proposal with respect to Securitization would grant prudential regulators the authority to permit supervised firms, where appropriate, to implement IRB modeling tools in connection with calculation of Securitization banking book default risk. This approach would permit regulators to allow IRB approved models to be implemented as an alternative to the standardized external ratings based approach.

We would encourage the Committee to consider aligning the trading book treatment and the banking book treatment regarding the implementation of IRB models. Granting regulators the authority to approve IRB modeling with respect to trading book default risk, would have the dual benefits of mitigating arbitrage between the trading and banking books, but would also be a positive step to encourage firms to develop risk based tools for Securitization trading books that incorporate performance history and utilize available loan level data to loan level performance; rather than being solely dependent on external rating agency bond surveillance. Understanding (1) that the quality of IRB modeling tools may vary by firm, and (2) the availability of loan level performance may vary by product and region, we would propose that regulators be granted the option of applying IRB tools at their discretion at the firm, region and product level.

In the event that the Committee is not able to reach a consensus regarding application of IRB modeling tools, with respect to the Securitization trading book, an alternative would be to consider application of the Modified Supervisory Formula. The Modified Supervisory Formula provides for risk based assessments of securitization positions that account for default history, cash flow structure and performance. Permitting global regulators the authority to apply this approach would create additional global consistency, as it reflects the approach that has been implemented by US regulators with respect to Securitization trading book treatment.

If the treatments of banking book and trading book are not properly aligned, the abovementioned highly liquid US securitized product market, with respect to which plenty of frequently updated information is available, may be badly affected.

3.2 Application of Internal Model to Interest Rate Risk and Credit Spreads

We understand that three components of risk charges (general interest rate risk, credit spread risk, default risk charge) are applicable consistently for securitized and non-securitized products. In the event that the Committee elects to apply standard approach for purposes of calculating default risk charges, then banks should be permitted at a minimum to apply risk based tools for purposes of calculating general interest rate risk and credit spread risk.

If firms are not allowed to use any internal model for all the three components of risk charge, the resultant capital charge will likely be too punitive, compared with proposed banking book treatment. Such extreme imbalance between trading book and banking book will cause firms to transfer

securitized products from trading book to banking book. That is the very opposite of regulatory arbitrage from banking book to trading book which was very common before financial crisis but was completely discouraged by the equal treatment of two books as a part of Basel 2.5 revision.

While we would encourage the Committee to consider model-based approaches similar to those outlined in the banking book proposals with respect to securitized products trading book, in the event that the default risk for securitized products remains standardized, we recommend that prudential regulators bi-furcate the treatment and allow use of internal model both for general interest risk and credit spread risk including securitized products. Applying standardized approaches for purposes of calculating interest rate and spread risk is overly punitive and not sufficiently risk sensitive. The Committee's scepticism for the use of internal models-based risk measurement against securitised products would be sufficiently addressed by standardized default risk charge. Therefore at a minimum the general interest rate risk and credit spread risk for securitized products should be allowed to be covered by internal model-based measurement.

In addition, under Basel 2.5 rule, only general interest risks from securitized product are allowed to be in the internal model-based measurement. And this is likely to lead to the inconsistency between regulatory VaR model and backtesting P&L because it is difficult to exclude credit spread risk contribution from backtesting P&L. By the inclusion of both general interest rate risk and credit spread risk, we can alleviate the inconsistencies and achieve more sound backtesting and P&L attribution analysis proposed by the new trading book rule.

3.3 Application of Index Hedging

We appreciate the Basel Committee on Banking Supervision consideration of the application of hedging tools for purposes of capital charges. We would ask that the Committee permit risk based correlation adjustments for index trading with respect to long cash positions, rather than only permitting correlation adjustments to the extent that the long cash bond exactly matches the component of the index.

In the US secondary markets, ABX and CMBX have historically been effective tools for financial firms to hedge securitization bond risk. While this strategy (similar to corporate and high yield index hedging) includes basis risk, and the correlation has been impacted by bond specific factors relative to the index (e.g. asymmetric credit performance), ABX/CMBX have been effective hedging tools.

A rule allowing for hedging capital charge credit only if the long positions is the same cusip as the index underlying, will almost completely eliminate any hedging benefit for capital purposes. ABX/CMBX indices reflect a sample of outstanding cusips, the incidence of "bond specific" correlation will tend to be low. The ABX/CMBX indices typically comprise 20-25 cusips that were selected at time of origination as representative sample, but is a sample. For example, with respect to Non-agency RMBS, 4 ABX indices were issued between July 2005 and June 2007. These indexes referred to 80 deals while 880 RMBS deals were issued in the same period.

Index	Unique Deals	Issue Period	Deals Issued in Period	% Count
06-1 AAA	20	2005 Jul-Dec	238	8.4%
06-2 AAA	20	2006 Jan-Jun	244	8.2%
07-1 AAA	20	2006 Jul-Dec	218	9.2%
07-2 AAA	20	2007 Jan-Jun	180	11.1%
Combined	80		880	9.1%

It is important to note, that these indices are actively traded by market participants, and have performance broadly correlated to the cash markets. For example during the period of 2013 in excess of \$165 billion notional of CMBX was traded by market participants.

By preventing market participants from applying any correlation benefit to reflect these hedges, the current protocols create significant disincentives for participants to utilize correlated hedging tools. In fact this dis-incentive, is significant enough that it will typically double the amount of capital that is held against a long position that is hedged through securitized products index products.

3.4 Consistency in Regional Approach

We understand that the importance and the depth of the securitization market varies widely by region. This variation is much more significant than sovereigns or corporate. For example, current outstanding by region are as follows:

	Total Outstandings (billions - US\$)
United States	1600
United Kingdom	374
Pan-European	92
Netherlands	255
Spain	161
Germany	62
Italy	177
Other	77
Portugal	37
Ireland	37
France	47
Greece	12

With this fairly broad dispersion, if regulators are not able to reach a unified consensus on approach, we recommend that prudential regulators be permitted to allow organizations they supervise to apply capital approaches that are consistent with those applied by regulators in the regions that they operate, rather than requiring application of a single approach across a global organization. Failure to allow regulators to apply such an approach would prevent regulators from adapting to evolving market conditions, and will create competitive disadvantages and inefficient allocation of capital. This would force certain firms to be overly reliant on rating agency methodologies, and would limit them from competing effectively with firms that operate in jurisdictions that permit more risk-based determinations.

The current trading book approaches have created significant competitive advantages/disadvantages for trading based location of parent regulator. For example, the US regulators currently apply the

SSFA approach for consolidated US financials vs. the Standardized Approach applied by Non-US regulators. This bi-furcation of approach has created significant capital impact. In many cases with respect to the US Non-Agency securitization market the capital impact with respect to the Standardized Approach is 500-1,000% higher than the risk based SSFA formula that has been implemented by US regulators. This is a large differential, particularly when considered against a backdrop of the US securitized products market reflecting \$1.6 trillion in outstandings and \$750 billion in trading activity during 2013. Also, the Standardized Approach requires financial institutions to rely on analysis performed by rating agencies, rather than permitting them to apply a more risk based approach with respect to their portfolio, despite the availability of abundant performance information.

3.5 Timing of Trading Book and Banking Book Implementation

We understand the complexity of implementing changes to the trading book and banking book regulatory requirements. We recommend that the Committee address and implement changes to the trading book and the banking book promptly, simultaneously and on a unified global basis. Delaying implementation of updated capital markets rules, will result in extending the current competitive capital imbalances that exist based on jurisdictions that have approved and implemented Basel 3 with respect to securitized products (Europe/Asia), versus jurisdictions that have delayed implementation or modified implementation (the United States). In addition, failure to have implementation of trading book and banking book updates occur simultaneously, increases the likelihood of arbitrage in favor of banking book treatment with respect to securitization capital markets activity. This arbitrage towards banking book can create long term dislocation in capital allocations.

4. Inherent Limitation of P&L Attribution Analysis

Nomura would like to emphasize the inherent limitation of P&L attribution analysis for the purpose of VaR model validation. One issue of concern is the closing time difference of market data series used in risk and P&L calculation. In the calculation of risk, particular market close timing is chosen per each risk factor in globally consistent manner for the purpose of producing risk sensitive VaR aggregation and limiting the number of market data series to a manageable level. On the other hand, regional market close is chosen for each regional P&L calculation and added up globally as general practice in the finance department. If the autocorrelation of daily returns is approximately zero, daily P&L finance and theoretical P&L of risk can have close-to-zero correlation due to this market timing difference issue.

Another issue of concern is the use of proxy time series. Appropriate proxy time series usage is permitted for risk calculation for the purpose of obtaining sufficient length of time series for entire VaR calculation period. In order to account for specific risks which are not captured by proxy times series, idiosyncratic factors with zero correlation to other time-series are generally introduced in the risk calculation. These idiosyncratic factors cannot be easily translated to risk theoretical P&L that can be comparable to finance P&L.

Our view is that the P&L attribution can be done, but the approach needs to be carefully specified; paying close attention to the practical implementation. Where violations are seen in terms of actual vs. theoretical P&L differences, these need to be highlighted and discussed with the regulator as is typically done with current back testing exceptions, as opposed to mechanically excluding a desk from internal model based capital.

5. Explicit Capture of Basis Risk in the Revised Standardised Model

Nomura would like to emphasize the importance of appropriate capture of basis risk in the revised standardized method. Current proposal of revised standardized method indicates only 90% netting benefit will be recognized to account for basis risk in the GIRR/CSR framework even if long and short

discounted cash flows⁵ falls into the same vertex. This 90% offset floor can lead to a significant capital overcharge for large gross size interest swap/credit derivative portfolio.

Nomura strongly supports the proposal from Canadian Bank Association⁶ that basis risks in GIRR/CSR framework should be captured more explicitly by allocating cash flows to different interest rate/credit spread curves such as “government”, “OIS swap”, “1m Libor swap”, “6m libor swap”, “Bond” or “CDS.

For interest rate/credit spread cash flows that are allocated to same currency, term and curve, 100% netting should be allowed. For interest rate/credit spread cash flows that are allocated to same currency, term but different curve, 90% netting floor (depending on QIS outcome) should be applied. By this approach, unnecessarily large basis risk charge for long and short cash flows from identical interest rate/credit spread curve can be avoided.

⁵ Nomura supports risk sensitivity approach over cash flow approach but we just keep original FRTB proposal in this context.

⁶ CBA Comments on Trading Book Group’s Request for a Revised Standardised Approach - January 6th, 2014.