

POSITION PAPER



WSBI-ESBG COMMON RESPONSE TO THE BCBS CONSULTATION ON THE FUNDAMENTAL REVIEW OF THE TRADING BOOK

WSBI-ESBG (World Savings and Retail Banking Institute -
European Savings and Retail Banking Group)
Rue Marie-Thérèse, 11 - B-1000 Brussels
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The World Savings and Retail Banking Institute (WSBI) and the European Savings and Retail Banking Group (ESBG) welcome the opportunity to share its views on this consultative document on the fundamental review of the trading book.

1. General considerations

We strongly welcome the Basel Committee for Banking Supervision's deliberations aimed at addressing the current framework's shortcomings. Nevertheless, we have several doubts and concerns with regards to this proposal that we would like to share with the Basel Committee. Generally speaking, we consider that 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. We are also concerned by the costs in terms of internal reorganisation to adapt the structures to the new provisions.

1.1. Boundaries between the trading and the banking book

With regards to the boundaries between the trading and the banking book the Basel Committee has put forward a new proposal. In the 2012 proposal the Basel Committee suggested two options to differentiate the trading from the banking book: a trading evidence based boundary and a valuation based boundary. The 2013 proposal for a revised boundary on the definition of the trading book includes a set of qualitative criteria. However, some of these criteria have to be designated to the trading book and some to the banking book. In the explanation, the Basel Committee states that a capital charge for interest rate and credit spread risk for the banking book is expected. Therefore, we understand that implicitly the Basel Committee is putting forward a set of new requirements for the banking book which may result in higher capital charges for the banking book. We also consider that the expected increase in the capital charge for the trading book should be part of the analysis of the QIS.

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.



1.2. Boundaries between standardised and internal models approach

As mentioned above, we consider that as a result of the new rules the implementation effort to incorporate the new changes to the existing models will be very high. The task of interpreting the new market risk metrics as well as deriving appropriate governance policies is becoming far more demanding. This will not only apply to banks with internal models but also to banks that have to face the introduction of the revised standardised approaches. Furthermore, with regards to the boundaries between the internal model and the standardised approach a floor between the internal model and standardised approach has still been included in the proposal but apparently no agreement has been reached at this stage.

1.3. Revised internal models

With regards to the revised internal model based approach the changes proposed will likely lead to huge efforts and costs for banks. Seemingly, the internal model approval will be from now on very tough. For medium size banks in particular it will be very costly to set up an internal model along the trading books, so these banks will most likely need to make a strategic decision concerning internal models. Therefore, as a result of all these obstacles mentioned above, we wonder whether the supervisor can force banks to use internal models.

1.4. Revised standardised approach

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. Instead, its complexity will have rendered it virtually unfeasible for smaller banks. Furthermore, in light of the clearly dwindling margins in the original lending business or, moreover, commission-related operations, this standardised approach will trigger 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.

Concerning the revised standardised approach, we recommend a clear description of the calculation of the capital requirements. Furthermore, concerning the revised standardised approach, we believe that the use of different risk weights and correlations should be limited 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. We also consider that more analysis should be done in the upcoming QIS. Therefore, we would like to recommend that the Basel Committee reviews its proposal on the review in order to achieve the following objectives:

- The determination of capital charges should be described more clearly;



- Different risk weights and correlations should only be used where these parameters are materially different and where notional positions can be assigned to these parameters according to readily observable characteristics;
- The scenario-matrix approach for the treatment of non-delta option risk is not further performed and instead the extended aggregation approach is more fully developed.

Concerning the treatment of credit risk, and in particular the non-securitised credit exposure, a new capital charge for credit spread risk that also covers migration risk has been envisaged. Furthermore, the current Incremental Risk Charge (IRC) will be replaced by the Incremental Default Risk (IDR) that will have to be calculated weekly, and will also apply to sovereigns. The question arises as to whether an overlap between the new credits spread risk and IDR may occur and how this could be solved.

We would also like to express our doubts concerning the application of the voting rights at national discretion regarding the treatment of sovereigns in the standardised approach since this will most likely undermine harmonisation across Europe.

The proposal also introduces several risk factors for the calibration of market risk so as to incorporate illiquidity which is a key assumption of the 10 day VaR treatment of market risk. With regards to the calibration of stress conditions the new proposal suggests a confidence level of 97.5%. We have doubts as to the calibration of the Expected Shortfall (ES) in stressed conditions as the ES goes beyond the VaR. Furthermore, long-term horizons will probably lead to higher complexity. Additionally different stress periods for different risk factors will most likely increase complexity.

1.5. Clarify the Draft Accord text

With regards to the clarification of definitions and terms, we appreciate the effort that the Basel Committee has made, in particular, to describe the de-composition of common instruments (paras 73 – 90). This may help, in particular, small and medium-sized banks although the draft Accord text is not ready for implementation. In particular, the draft Accord text should:

- Use terms in their usual meaning (for example the common meaning of “notional value” is the face value, not the market value of an instrument – however the latter seems to be the meaning e.g. in paras 49, 90)
- Use each term with just one meaning (for example in para 51 the term “notional position” seems to refer to the full market value of bond and to the cash flows of the bond at the same time)
- Describe clearly the determination of the “delta-equivalent position” of an option (for example the underlying of a cross-currency option is the cross-rate between the two currencies – neither para 57 nor para 62 indicates clearly how the delta-equivalent positions are to be determined).



We believe that a clear description of the determination of the capital charges is a necessary condition for meeting the Committee's aim of making the capital charges more comparable.

1.6. Streamline the risk weights and correlation parameters

We welcome the fact that the new standardised approach proposal incorporates hedging and diversification more fully than the current one. However, we believe that a better trade-off between risk sensitivity and simplicity could be achieved if different risk weights and correlations are only used where these parameters are materially different. Furthermore, we also consider that better modelling of basis risks is required; otherwise unhedged positions would be incentivised. This should also help to keep the costs for practical implementation (in particular changes to IT systems) within manageable limits. Finally, it is essential for a convergent implementation that notional positions are assigned to these parameters only according to readily observable characteristics.

In light of these principles the Committee could improve the revised standardised approach in particular by making the following simplifications:

Risk	Recommendation	Background
General	Clarify what is meant by "identical instruments"	The draft Accord is not clear on the decomposition of options. Would the underlying of e.g. a bond option count as "identical" to a cash position in a bond although the bank does not receive the coupon payments before the expiry of the option?
General	Provide worked examples on the decomposition of options	So far, no example has been provided for the treatment of delta risk of options.
CSR: non-securitisation	For buckets 1, 2, and 6 (and 7, 8, and 12) refer to the definitions in the banking book (para 105).	<p>The standardised approach for credit risk has a detailed categorisation of sovereign risk. For example, local governments are guaranteed by the central government, but for other types of sovereigns they are not. This categorisation should read across to the trading book.</p> <p>The meaning of the term "financial" should be clarified according to the categories available in the banking book (e.g. regulated as a bank or investment</p>



		<p>firm).</p> <p>The term “national bank” is defined for the US, but not elsewhere.</p>
	<p>The buckets 3 to 6 (and 9 to 12) should be collapsed into a single bucket, with certain categories of sovereign debt removed from bucket 6 (and 12) (para 105).</p>	<p>The risk weights across these buckets are very similar (cf. para 106). The economic rationale for some of the correlations is not clear (e.g. buckets 3 and 9 both refer to “basic materials, energy, industrials”, but the correlation is 0 whilst buckets 3 and 12 refer to different industry categories, but the correlation is 0.4.</p>
	<p>Do not differentiate correlations by maturity difference (para 109).</p>	<p>The correlations that apply to cash flows of the same issuer are fairly similar for a maturity difference of up to or above five years. Yet, the operational cost for implementing this correlation is large as the bank would have to:</p> <ul style="list-style-type: none"> - extract the maturity of each cash flow from its trading systems; - transfer it to its system for supervisory reporting (henceforth: reporting system); and - within the reporting system compare the maturity for each pair of cash-flows from the same issuer.
CSR: securitisations	<p>Clarify: Are cash flows to be mapped to vertices (i.e. a pre-defined grid of maturities) or is the contractual maturity used? (para 116)</p>	
Equity risk	<p>The buckets 1 to 4 (and 5 to 8) should be collapsed into a single bucket (para 126).</p>	<p>The risk weights for the four buckets are of similar order of magnitude (para 127), likewise the correlations (para 129).</p> <p>For certain firms, the industry is not readily observable</p>



	Clarify: which countries are emerging markets and how are firms to be assigned to the category?	The Committee should publish a list of countries. Firms should be categorised according to where they are legally domiciled as this is readily observable.
Commodity risk	Categorise by commodity type only.	<p>The meaning of “grade”, “location” and “maturity” is left undefined in the draft Accord text. E.g. for ‘heating mail’ does this mean the address of the customer to whom the oil is to be delivered?</p> <p>The operational cost of differentiating correlations by maturity difference is large as the bank would have to</p> <ul style="list-style-type: none"> - extract the maturity (maturities?) for each instrument from its trading systems; - transfer it to its reporting system; and - within the reporting system compare the maturity for each pair of instruments (decomposed instruments?) with the same commodity as underlying.
FX risk	Use a single net cash-flow per currency (para 140).	Basis risk within a currency is already captured as general interest rate risk. The introduction of term buckets double-counts this risk.
Default risk (non-securitisations)	Clarify that “notional” means face value (para 147).	This is how the term is used in the worked example (p. 49).
Default risk (securitisations)	Double-check references to the steps of “Default risk (non-securitisations)”.	For example, step 6 is not concerned with calculating JTD (para 160).
	Clarify the term “asset class” (para 162).	ABS and RMBS are given as examples, but there is no list.



About WSBI-ESBG (European Savings and retail Banking Group)

WSBI-ESBG – The European Voice of Savings and Retail Banking

WSBI (World Savings Banks Institute) is one of the largest international banking associations and the only global representative of savings and retail banking. Founded in 1924, WSBI represents more than 6,150 financial institutions from 89 countries. It works closely with international financial institutions and donor agencies and promotes access to financial services worldwide in both developing and developed regions. At the end of 2011, these institutions operate through more than 227,000 branches and outlets, employ more than 2.2 million people and serve more than 600 million customers. Assets of member institutions amounted to more than US \$15.6 trillion at the end of 2011. Together, member banks conducted operations through more than 227,000 outlets.

ESBG (European Savings and Retail Banking Group) members represent one of the largest European retail banking networks, comprising of approximately one-third of the retail banking market in Europe, with total assets of over €7,300 billion, non-bank deposits of €3,480 billion and non-bank loans of €3,950 billion (31 December 2012). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

WSBI-ESBG members are typically savings and retail banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their region. WSBI-ESBG member banks have reinvested responsibly in their region for many decades and are a distinct benchmark for corporate social responsibility activities throughout Europe and the world



European Savings and Retail Banking Group – aisbl

Rue Marie-Thérèse, 11 ■ B-1000 Brussels ■ Tel: +32 2 211 11 11 ■ Fax : +32 2 211 11 99

Info@wsbi-esbg.org ■ www.esbg.eu

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