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Fundamental Review of the trading book: outstanding issues - consultative document

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as representative of the entire Austrian banking industry, appreciates the possibility to comment on the Consultative Document “Fundamental Review of the trading book - outstanding issues” and would like to submit the following position:

We see in general a step up in complexity regarding risk measurement models and connected validation methods. The formulated requirements for internal as well as standard models will lead to a significant increase in qualified staff (validation, modeling, risk managers, auditors and IT).

We would see the requirement to lower the cost burden for banks when implementing regulatory standards. With regard to this topic we would like to contribute ideas and amendments to the proposed solutions. The revised framework is mainly targeted at big banks with significant trading activities. We therefore expect a negative impact to the current employed business model of a universal bank with a small customer driven trading book.

Architecture of Capital requirements

We suggest a five tier approach to cover the various business models and keep the complexity and costs out of small and medium sized banks and business models with no or very limited trading activity.

1. No own trading activity: We suggest to provide the existing possibility to have a banking book only.
2. Residual/very small trading activity: We suggest to retain the existing small trading book regulation.

3. Small trading activity - keep the existing standard model regulation (rename to simplified approach)
4. Normal trading activity: We suggest to provide the revised standard model here, also as a fallback for internal models.
5. High / complex trading activity: revised internal model.

The set of criteria for assignment to the capital methods should contain at least the following:

- P/L of trading activities
- Organizational structure (traders, desks, markets, products)
- Open Position sizes and trading turnover
- Complexity of products (digital payoffs, path dependent products require internal model)

The addition of basis risk (either method proposed) brings a much higher complexity to small institutions, therefore we suggest that this shall be only valid for bigger institutions. For example a criteria from the Prudent valuation regulation could be reused. Institutions shall only implement basis risk in the standard model if they have to implement the Prudent valuation core approach as well.

Internal risk transfers between the banking book and the trading book - GIRR

We would prefer option 2, which gives the banks much greater benefits in managing the IR risk towards the banking book. This would make it possible to internally hedge individual banking book exposures with the trading operations and only to go to the market for greater exposures with a cost advantage. But there are two topics not satisfying in the current proposal:

- a. The sentence (b) : the internal risk transfers and external hedges of those transfers cannot be used to offset interest rate risk arising from trading book activities:

This would yield two trading books in one entity, where the economic risk in one market would be significantly different from the regulatory capital requirements not allowing the offsetting from positions in the same risk factors.

We recommend to totally discard point (b)

- b. The IFRS regulation for Hedge Accounting does only allow option 2 currently, the new regulatory IRT transfer possibility would have to be reflected in the IFRS regulation as well.

Regulatory standard implementations of standard/simplified models

Regulatory reporting requirements are currently very high. Basically the same information is reported multiple times. Furthermore also the current requirements would put the authorities in the position to calculate all of the required figures.

In terms of economical aversion of costs it should be analyzed if the capital figures for the simplified / standard model could be calculated by the regulator itself or a standard IT solution can be provided to the banks.

This would have the advantage of lower costs for the whole banking system and a much better comparability of figures across all jurisdictions.

Currently the same models must be implemented by

- each bank
- auditors / external validators
- the regulator - development of the metrics and for comparison

Treatment of illiquid positions / prudent valuation guideline / introduction of liquidity horizon

Aligned approaches

Although the Committee has recognized that decisions to introduce liquidity horizons as part of market risk metrics in order to capture the risk of illiquidity will lead to partial overlap with prudent valuation requirements, we would like to stress this once again.

We clearly would like to avoid the situation when prudent valuation adjustments, which include also illiquidity adjustments, are calculated differently for different portfolios. Moreover, since prudent valuation is based on accounting categories, while trading book is not linked to trading assets / liabilities explicitly, the differentiation in illiquidity charges will create unnecessary difficulties and confusions.

It is also necessary to underline that principles behind illiquidity risk treatment under the market risk framework as well as under the prudent valuation requirements should be the same - otherwise the shift of positions between banking and trading book (if it is happening) will lead to indirect capital benefits. (We are aware of the Committee proposal to permit capital benefits in case of switch between portfolios; however we fear that in this particular situation it still may be possible, since prudent valuation adjustments are not directly included into capital requirements.)

We would like to draw the Committee's attention to the topic of illiquidity. This is still understood differently from a prudent valuation point of view and capital requirements point of view. In the Discussion paper on prudent valuation issued by EBA in July 2014 it is stated that valuation adjustments are to be defined with 90% certainty. On the contrary under the revised market risk framework potential losses are measured with 97,5% confidence interval (one should keep in mind that the last is to be defined within the expected shortfall framework calibrated under the stress conditions).

Illiquidity adjustments for banking book

We completely agree with the Committee opinion that market liquidity and increase of liquidity spreads is a crucial question for bank solvability, especially in times of crises events on the market. However, we would like to underline that it is a particular problem of trading

book, but is also relevant for banking book exposures, booked in at fair value accounting categories.

Thus the existence of a single framework for capturing this risk will make it simpler both for the supervisors and the management of banks.

Banking book exposures, booked in at purchase price according to national accounting standards are less effected than trading book exposures because of the lower cost or market value rule.

We would propose to incorporate a market liquidity capital charge as an incremental capital charge, which can be monitored and managed separately. An incremental capital charge should be designed in a way that it can be easily incorporated into the prudent valuation framework. In light of the Committee's consideration to incorporate interest rate risk and credit spread risk of banking book into Pillar 1 capital requirements it would create additional benefits for the supervisors.

Liquidity horizons

We would also like to draw the attention to the issue that liquidity of a particular position depends on both internal and external factors, namely: liquidity of the market in general, liquidity of certain issuer and issue, concentration of position in relation to market size; to capture all this nuances in a single framework seems to be an ambitious task. Thus we understand the will of the Committee to simplify the issue via introducing standard liquidity horizons on a level of risk factors. However we would like to underline that the proposed approach seems to be too simple, and a lot of crucial factors influencing market liquidity are remaining out of scope (like market liquidity or concentration). This may lead both to overestimation as well as to underestimation of capital needs. As a minimum solution we would propose to incorporate different currencies /currency pairs into the proposed liquidity horizons.

Disclosure platform for risk factor / market data

We observe that it is very difficult and expensive for a bank to get the market data to develop quantitative models for assessment of market liquidity and concentration risks. Transaction level data throughout the markets are usually not easily available for banks.

Regulators have broader access to data and would need the data as well to understand the current state of financial markets. Therefore we would see it as an advantage if the regulator could disclose the appropriate data for banks usage.

Participations

The current requirement to hold all equities in the trading book is against many banks current practice of having a participation book that is not traded on a trading desk and is not steered on daily prices.

There should be a solution for investment in equities. This should include criteria for the assignment to the trading / banking book.

Revised Internal model approach

Move from Value-at-risk (VaR) to Expected shortfall (ES)

ES is a useful measure. However, the inability of VaR to capture tail risk should not be the principal argument in favor of ES - ES is just a different measure; its purposed ability to capture tail risk is not measure-inherent. For ES to capture any tail risk, or to provide a different view on it, the underlying distributions must be correct in the first place. Given the great difficulty in assuming any tail behavior as defined by distribution choice and parameterization, ES is not better in giving an accurate view on those tails, as they are in fact determined not by the measure, but by the entity (the joint distribution) being measured/estimated.

Overlapping returns

On using/allowing overlapping returns: At first sight, long-period returns seem useful to capture risks. They, of course, would require unreasonably long time series. So the choice is between short returns, and scaling of results, vs. long, overlapping returns. In our view, the former approach is preferable. Scaling generally behaves quite well in most circumstances; the approach is very simple, easy to handle, and transparent in the sense of comparability and use of rules-of-thumb. The latter approach introduces autocorrelation of returns, which prohibits simple checks or analyses.

Overlapping returns, due to their properties, are much less transparent.

Stability of ES model not improved in comparison to VaR

ES provides some benefits. We disagree with the statements "more stable model output" and "less sensitive to extreme outlier observations" - VaR has these properties, as quantiles are not greatly affected by extreme tail behavior; ES, however, is likely to be influenced to a non-trivial degree by both outliers and tail distribution assumptions. (Except if the period of returns used for calculation is kept constant in a stressed ES setting.) Nevertheless, we welcome the increased weight given to this additional measure.

General comment on risk metric extensions

General remarks to section 1.5, as well as to default handling, and liquidity horizons in general:

Internal models are quite rigid, and tuned to one specific purpose. Alternative and additional risk views are often difficult to natively incorporate into the VaR/ES framework. For example, extreme events, or liquidity issues are conceptually (e.g., outliers don't affect VaR) or numerically (e.g., longer simulation periods with various additional assumptions) not well-suited to the scope of a typical return distribution estimation. Whenever possible, such separate risk assessments should be made possible by specific stress tests. They are easy to define consistently, and can be calculated consistently within the overall distribution approach. (This also applies to the artificial restriction of market observed diversification effects.)

P&L attribution / Backtesting

Since the original treatment in the “revised market risk framework” has not been developed further in the new consultative document “outstanding issues”, one of the main open questions is if the economic backtesting procedure shall follow the accounting P&L or the FO P&L scheme. Either one has advantages and disadvantages. The FO P&L is daily available on a granular level required for the P&L attribution comparison where the accounting P&L is not available on daily basis in most of the small to medium sized banks.

“Revised market risk framework”, Section 2.2, (ii), “P&L attribution requirements”: A minor point - should “mean of difference” be “mean of abs(difference)”? And should standard deviations be used instead of dimension-wise less expressive variances?

Partial uses not defined

Currently there are some banks who have a partial use (risk factor level) approved. The paper does not give any guidance on how to deal with partial uses particularly validation and backtesting requirements as well as P&L attribution.

Organizational separation of validation and model development

With regards to the original consultation paper “Fundamental review of the trading book: A revised market risk framework, Annex 1, D, 2, (c), “A distinct unit must conduct the initial and ongoing validation of all internal models”:

This strict separation between modellers and validators is a very cost-intensive and possibly prohibitive requirement.

Since this point has not been addressed in the new consultative document “outstanding issues”, we propose that the regulator provides a set of criteria when a full independent validation team has to be established. For medium sized banks this is a criteria which will certainly withhold the bank from developing internal models.

Calculation of FX-sensitivity in the standardized approach

Assuming that FX_k is quoted in FOR/DOM (the other direction does not seem to make sense in the context of the formula), the formula should be independent of the absolute level of the exchange rate, thus the FX_k in the denominator seems superfluous. (The formula represents the (numerical) spot/raw FX-delta, and as such yields results not in the reporting currency, but in the respective foreign currency. Taking the FX_k out of the denominator gives s_{ik} in the reporting currency.)

Please give our concerns due consideration.

Yours sincerely,

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