

To the Basel Committee on Banking Supervision

Division Bank and Insurance
Austrian Federal Economic Chamber
Wiedner Hauptstraße 63 | P.O. Box 320
1045 Vienna
T +43 (0)5 90 900-DW | F +43 (0)5 90 900-272
E bsbv@wko.at
W <http://wko.at/bsbv>

Your ref., Your message of

Our ref., person in charge
BSBV 189/Dr. Egger

Extension
3137

Date
18 June 2018

Consultation on revisions to the minimum capital requirements for market risk

The Division Bank and Insurance of the Austrian Federal Economic Chamber, as legal representation of the entire Austrian banking and insurance industry, appreciates the possibility to comment on the above mentioned Consultation Paper and would like to submit the following position:

We believe that the simplified approach is a necessary supplement to the Basel III provisions on market risk and we welcome the initiative of the Basel Committee to introduce simplified alternatives. Still, any regulatory simplifications for small and less complex banks should not be subject to excessive capital requirements. The simplified approach is an expression of the principle of proportionality. We consider the proposed level of the multipliers as too high. Especially, the multiplier for interest rate risk should be set at a level necessary only. Portfolios of banks potentially subject to the simplified approach usually comprise simple and conservative products. In this light, we believe that the multiplier for general and specific interest rate risk should be set at 1,25%.

A2 Revisions to the curvature risk capital requirements (page 16)

Paragraph 53(d) in the Revisions is only given “for CSR, equity and commodity risk classes”. This is misleading: According to 59(e) [pre-Revisions], “The GIRR curvature risk factors are defined along only one dimension”, meaning there is only one CVR_k per currency, and $S_b = CVR_k$. This step is not well-defined any more, since post-Revisions, there are CVR_{k+} and CVR_{k-} , and Paragraph 53(e) says “ $S_b = \sum CVR_{k+}$ for all risk factors in bucket b when, in (d), the upward scenario has been selected for bucket b, $S_b = \sum CVR_{k-}$ otherwise”. But since 53(d) is not applicable to GIRR curvature risk, how is S_b to be determined? It seems the formula is meant to be $S_b = \max[CVR_+, CVR_-]$, but then EITHER the formula in 53(b) of the version *before* the Revisions OR a (trivial) version of 53(d) in the Revisions seems to be required for GIRR curvature risk.

A.3 Revisions to FX risk factors and curvature risk capital requirement (page 17)

Call the reporting currency DOM, and any other currency FOR. Then, the sensitivity for the Delta FX charge, which, according to Paragraph 67, is “expressed in the reporting currency of the bank”, must contain values expressed in DOM, i.e. the $V_i(1.01 \text{ FX}_k)$ and $V_i(\text{FX}_k)$ must be in units of DOM.

However, the FX_k is expressed using the convention units of FOR per unit of DOM, or, in Wystup’s notation, DOM-FOR. However, exchange rates are represented in risk systems and FO-systems mostly in quotation FOR-DOM, since this follows a simpler stochastic process (in the domestic riskneutral measure) when the exchange rate is simulated e.g. in path-dependent pricing modules. It therefore seems more appropriate to calculate the sensitivity with FX_k quoted in FOR-DOM in order to avoid implementation problems.

A.5 Revisions to the treatment of liquid FX pairs (page 18)

The formulation “first-order crosses” in Paragraph 120 is in our opinion misleading: FN2 implies that inverses of liquid currency pairs are also liquid currency pairs; in the sense that $\text{EUR/AUD} = \text{EUR/USD} \circ \text{USD/AUD}$ is a 1st-order-cross of the liquid currency pairs $\text{EUR/USD} = (\text{USD/EUR})^{(-1)}$ and USD/AUD .

But then, since for every currency (CCY) in the list of currency pairs, the pair (USD, CCY) exists in the list of liquid currency pairs (except trivially for USD), the set of 1st-order-crosses exhausts the set of all possible pairs made up of currencies in this list. This leads to the following:

CLAIM: The set of 2nd-order-crosses, or indeed n-th-order-crosses, would not contain any elements not already contained in the set $\{\text{liquid currency pairs}\} \cup \{\text{1st-order-crosses}\}$.

PROOF FOR THE CLAIM: For any two currencies CCY1 and CCY2, both $\neq \text{USD}$, but from the list of liquid currency pairs, USD/CCY1 and USD/CCY2 are in the list of liquid currency pairs, therefore $\text{CCY1/CCY2} = (\text{USD/CCY1})^{(-1)} \circ \text{USD/CCY2}$ is in the list of 1st-order-crosses. If $\text{CCY1} = \text{USD}$, CCY1/CCY2 is in the list of liquid currency pairs. If $\text{CCY2} = \text{USD}$, then $\text{CCY1/CCY2} = (\text{USD/CCY1})^{(-1)}$ is in the list of inverses of liquid currency pairs, and thus itself a liquid currency pair according to FN2.

Since CCY1 and CCY2 were arbitrary (currencies from the list of liquid currency pairs), and 2nd- or higher-order-crosses are always subsets of $\{\text{CCYs from the list of liquid currency pairs}\}^2$, or, of the form “CCY1/CCY2”, it follows that no new currency pairs with lower risk weight can be built from 2nd- or higher-order crosses of liquid currency pairs. □

B.5 Revisions to Appendix B and Glossary: PLA definitions (page 29)

The (re)definition of the hypothetical P&L in the FRTB Revisions assumes that it is calculated in the system which produces the reported daily P&L (generally the FO-system). Also, the TRIM Exercise requires the pricing methods of hypothetical P&L to be the same as the pricing methods of the economic P&L (defined as the pricing methods of the FO-system).

However, back-testing refers to a kind of P&L which relies on “hypothetical changes” (completely similar to CRR):

“To the extent that backtesting programs are viewed purely as a statistical test of the integrity of the calculation of the risk measures, it is appropriate to employ a definition of daily trading

outcome that allows for an “uncontaminated” test. To meet this standard, banks must have the capability to perform the tests based on the hypothetical changes in portfolio value that would occur were end of-day positions to remain unchanged.” (Minimum capital requirements for Market Risk; BCBS 352, p72).

This is in line with the EBA’s formulation of hypothetical P&L as a ‘pure’ testing of the model. (cf. RTS on assessment methodology, final draft)

However, the new definition of the hypothetical P&L in the FRTB Revisions; BCBS 436 (calculated in the FO-system) is understood to have systematic differences to the P&L calculated by the valuation engine in the risk control unit:

“Residual operational noise arises from computing the HPL and RTPL in two different systems at two different points in time.” (FRTB Revisions; BCBS 436, p27).

The expression “residual operational noise” doesn’t cover up the fact that two systems’ calculations will have systematic deviations a) contaminating the statistical test, and b) potentially undermining the independence of the risk control unit. (Art. 368 (1b) CRR: A “risk control unit that is independent from business trading units” is a regulatory requirement.)

Therefore, hypothetical P&L also has systematic differences with the original, tried-and-tested concept of a P&L based on “hypothetical changes in the portfolio’s value” in the CRR, generally calculated in the valuation engine of the risk control unit.

There is reason to assume that the systematic differences of HPL and RTPL run counter to the declared goal of a ‘pure’, ‘uncontaminated’ statistical back-testing of the VaR-Model implemented in the valuation engine of the risk control unit. Similarly, the validity of the statistical tests of the PLA could be critically questioned in the face of the aforementioned systematic differences. (“the HPL used [for PLA] should be identical to the HPL used for backtesting purposes” (FRTB Revisions; CBS 436, p.26)).

The question therefore is if the “tests based on the hypothetical changes in portfolio value” for back-testing and PLA should be based on the newly defined concept of the hypothetical P&L if it must be calculated in the FO-system resp. the system producing the daily reported P&L (generally outside the risk control unit). Delegating responsibility to the FO-system (potentially proprietary, with undisclosed code basis) to calculate HPL, so that pricing methods in business trading units and the risk control unit are identical by definition, creates pressure to also calculate the VaR in the same (FO-)system and to abandon independent risk systems/in-house developments. It seems like a loosening, rather than strengthening, of risk control standards, and rather weakens the standing of as of yet independent risk control systems in model banks. Also, it makes the diversity of pricing engines subside, potentially leading to systemic pricing errors.

We ask you to give our remarks due consideration.

Yours sincerely,

Dr. Franz Rudorfer
Managing Director
Division Bank and Insurance

