

20 February 2015

Basel Committee on Banking Supervision
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COMMENTS ON: FUNDAMENTAL REVIEW OF THE TRADING BOOK - OUTSTANDING ISSUES

We thank you for the opportunity to provide comments on the third consultative paper on outstanding issues related to the fundamental review of the trading book- capital requirements. We have endeavoured to capture all the comments by our members below and would also like to inform you that we are also in support of the ISDA response document.

We fully support that this consultative document aims to contribute to a more resilient banking sector by strengthening capital standards for market risk and forms part of the Committee's broader agenda to reform regulatory standards for banks in response to the financial crisis. We furthermore recognise the Committee's incorporation of industry feedback since the previous round of consultation; in particular we welcome the continued development of the sensitivity based approach over the cash-flow based approach for standardised calculations.

1. Executive Summary

The new standardised approach, although much more aligned in terms of how banks actually measure their market risk exposure, requires much more data and system capabilities (close to the level of IMA approval). For South African banks, this is typically not a major issue; but in our African subsidiaries, that currently report only under the standardised approach, the implementation of the new proposed standardised approach is a significant challenge due to their systems and data capabilities not been able to deliver what is required under the new standardised approach without added cost and skills requirements.

We have a concern with the new regulations regarding the transferring of interest rate risk in the Banking Book ("BB") to the Trading Book ("TB"), and the restrictions on the offsetting of this risk with similar risks in the TB prior to hedging it out.

We will elaborate further on this below.

2. Proposed Rules on Internal Risk Transfers (IRT)

The IRT is a way of effectively managing risk within an organisation in the manner most efficient to the bank. Efficiency includes minimising the costs related to external

trades, limiting exposures to external counterparties, as well as optimising risk management using specialist, centralised skills.

Risk transferred to the TB might diversify existing risks in the TB and the remaining risk is then managed within risk limits and appetite levels of the TB. This process allows for robust risk management for the entity and the industry as a whole, leading to lower market volumes and volatility. It also enables internal risk diversification before offsetting any remaining risks externally, which (in our view) is one of the key functions which banks are meant to fulfil in the economy.

The IRT process is however not necessarily used in isolation to manage interest rate risk in the banking book ("IRRBB"). Certain trades are externalised, for example when designated into a hedge accounting solution, or to comply with other accounting requirements.

As an illustration, when the bank offers market making services on derivatives to its customers, it is usual that the function in charge of mitigating IRRBB (Asset and Liability Management, ALM and/or Treasury) executes all or some of its risk mitigating derivative instruments with the TB of its own bank. Such IRT processes are efficient for the bank, since they minimise the number of desks facing the market and benefits from the diversification effects between trading book customers' transactions and ALM Treasury's transactions, which effectively reflect risks originated from BB customers.

The TB desks are subject to a risk management framework, notably limits to their market risk exposures that de-facto binds them to materially offset the risks in relation to customers' transactions (including ALM Treasury's transactions) with external transactions. Any residual risk is subject to the market risk capital charge applicable under current Basel III standards. Therefore, the risk of arbitrages of the boundary due to imperfect external offsetting process is extremely small, and we do not see the need for additional measures, subject to the trading desk being well governed via the *market risk management framework*.

We believe the proposed IRT rules only restrict banks' internal risk management practices, without clearly identifying the risk that is being addressed. The consultation document points to capital arbitrage as the main motivation, but it is unclear how this manifests through the current market risk management processes and measures in place and why this will not be addressed by the work being done by the Interest Rate Risk & Credit Risk in the Banking Book ("IRRCRB") Task Force.

We are also concerned that the stated need to prevent capital arbitrage could have unintended consequences for how banks operate and how they manage their risk, if implemented in accordance with current proposals.

Arbitrage opportunities exist in the boundary definition. Having a clear definition of BB and TB instruments, and what constitutes risk, can be transferred between the BB and the TB is key in eliminating capital arbitrage. Once risk is transferred to the TB however, we believe it should follow the same capital treatment as the rest of the TB and be seen as an external trade given that the transfer reflects risk from external counterparties in the BB.

Capital is currently held in the TB for the total risk being managed by the TB team, which is a reflection of total fair value risk in the entity. Given the nature of BB trades, a portion of the risk might not be able to be hedged in the market, but together with other risks for which there is not a liquid market, may prove a natural offset.



2.1 Specific commentary on options provided in the consultation document

Option 1 in the consultation document would basically oblige ALM Treasury to mitigate all its IRRBB with external counterparts, which would decrease the bank's ability to benefit from diversification and natural hedging effects and would increase its counterparty risk and the related liquidity requirement.

Option 2, would have the very same detrimental impact as *Option 1* since, with a portfolio limited to ALM Treasury's transactions, there would basically be no possible diversification and natural hedging benefits.

Hence, both options would likely impact how banks are managing IRRBB with no immediately apparent benefits from a prudential and / or a risk management perspective.

While we understand the Committee's intention to distinguish clearly between the Trading and Banking Book activities, we would like to outline the potential impacts and would also like to address concerns in an alternative way.

The currently proposed Options 1 and 2 will have a significant impact on bank's risk management practice and capital requirements:

- Capital requirements will increase as any risk mismatch of TB and BB transactions will trigger capital charges under the TB environment. Currently, the overall position is measured after internal diversification. As a result banks can be charged for a risk that does not exist from an overall economic perspective, effectively meaning that capital requirements are being "grossed up". This approach would not be in line with for instance credit risk, where risks are allowed to be pooled when capital requirements are determined
- Aiming to minimise capital charges in the TB, banks could be forced to centrally manage BB risk positions in a BB environment and only transfer risks to the eligible TB which might already has an external hedge available. As a consequence this could lead to risks not been managed optimally, but rather in a manner that minimises capital charges. Furthermore the BB could be forced to keep risks which are not in the BB's interest
- Not allowing for internal risk diversification would synthetically increase market flows as all BB related hedge transactions would need to be externalised with the market. This effect increases costs for banks and will therefore have an impact on pricing and product offerings banks are able to make to BB clients (e.g. retail clients, fixed rate mortgages and corporate financing)
- Systemic risk is also likely to increase as a result of reduced diversification and increased market flows
- A possible change in market behaviour and introduction of moral hazards when banks do a "wash" trade between each other to move the risk to the traditional TB and circumvent the proposed increased governance
- Additional rise in counterparty risk exposure to banks with whom these trades would be executed
- In instances where some or all of the major banks are included in a single syndicated asset or liability structure, it would become impossible for those banks to externalise that risk without creating systemic risk within the

monetary system. This is especially true for the South African market with a small number of participating banks.

- The proposed Options 1 and 2 do not address how any existing IRTs, which is currently used as an offset against the TB, will be handled and specifically do not clarify whether these offsets will have to be unwound and externalised.

We therefore recommend that banks should retain the ability to transfer BB risk to the TB that allow diversification and natural hedging effects, subject to the mandates and limits of the TB and governance standards that meet supervisory approval.

The concern about capital arbitrage can be mitigated if there is full transparency in the risk transferred without having to resort to the options proposed in the consultation document.

We furthermore recommend that such IRTs are accompanied by reporting requirements that show the details of the risk transferred as follow:

- IRT-transaction should be executed solely with an IRT-eligible TB-desk
- The IRT must be documented with respect to the BB interest rate risk being hedged and the sources of such risk. This information must be reported regularly to supervisors
- Banks must have clearly articulated and documented process in place for identifying and quantifying BB interest rate risk to be hedged through IRT's. The methodology needs to be consistently applied, with any material changes in approach approved by the bank's Asset and Liability Committee ("ALCO") before implementation
- The IRT-transaction seen from the TB view is recognised in the TB market risk framework together with the other TB transactions
- The IRT-transaction seen from the BB view is recognized in the BB prudential framework.
- Each IRT-eligible TB-desk ('the desk') should:
 - List the financial instruments ('the instruments') the desk can use to service its customers (including internal customers)
 - Document the hedging strategy applied to the IRT in a transparent and comprehensive way
 - Meet specific requirements on an on-going basis to ensure risks are appropriately offset

Examples of such requirements include:

- The desk routinely stands ready to and actually executes the instruments in both directions, and is willing and available to quote or enter into long and short positions in the instruments, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the instrument
- Trades between BB-desk and TB-desk should be on similar commercial terms to trades executed with external counterparties
- The bank has established and implements, maintains, and enforces written policies procedures, internal controls, analyses and independent reviews identifying and addressing:
 - The financial instruments the desk is mandated to enter into

- The techniques and strategies the desk may use to manage the risks of its activity and the personnel responsible for ensuring that the actions taken by the desk to mitigate the risks
- The actions the desk take to mitigate promptly the risks of its financial exposure consistent with the limits; the products, instruments, and exposures the desk may use for risk management purposes
- The TB-desk should be subject to normal market risk management and monitoring practices and included in the bank's overall traded market risk framework
- Limits applicable to the desk should be based on and be consistent with the nature and amount of the activity offered by the desk and include:
 - The amount, types, and risks of its activities,
 - The amount, types, and risks of the products, instruments, and exposures the desk may use for risk management purposes,
 - The level of exposures to relevant risk factors from its financial exposure.

Moreover, we believe there should be continued interaction between the TBG and the TFIR on the issue of IRT. Given that the TFIR is doing a review of the prudential rules for IRRBB, we would assume that it would have some views as to the hedging activities that would be appropriate for banking book positions, and how these should be captured for regulatory capital purposes.

3. **Revised Internal Model**

Whilst the use of a base liquidity horizon of 10 days significantly simplifies the required system setup, the liquidity horizon scaling formula introduces a high level of operational intensity. For example, for a stressed ESR,S on the overall portfolio plus, say five components or asset classes (Interest Rate, Foreign Exchange, Equity, Commodity, Credit), it will be required to run Expected Shortfall for five different subsets of liquidity horizons (10-250, 20-250, 60-250, 120-250 and lastly 250). Additional calculations would also be needed to obtain ESF, C, ESR, C on the overall level.

With respect to liquidity horizons, "FX rates – liquid currency pairs" are grouped under the 10 day risk factor categorization and "FX rate (other currency pairs)" are categorized as 20 days with a footnote depicting which currency pairs are considered under this category. The footnote, however, lists many currency pairs that we are of the opinion should be considered as liquid, including but not limited to USDZAR. In addition we are appreciative of shorter liquidity horizons for FX and Rates risk factors, but it is questionable why currency pairs are being grouped in two separate currency pairs as there is a potential for FX triangular arbitrage.

On the matter of the Revised Standardised Model being considered as a possible floor to capital figures generated from the Revised Internal Model, we are concerned that a too conservative implementation could eliminate incentives for banks to maintain sophisticated risk systems. With the increase in complexity of both models, and the introduction of a mandatory model we believe that many banks might reconsider the use of the Internal Model – at great loss of an informative risk system that currently is the base of detailed risk analysis and comprehensive Stress Testing.



4. **Revised Standardised Model**

In terms of changes proposed to the standardised model and specifically concerning the capitalisation of basis risk, we believe further clarity would be required, specifically relating to the Disallowance Factor vs. the Correlation Method. Whilst we are in agreement that the Disallowance Factor method could possibly cause capitalization for basis risk where it does not exist, we perceive the Correlation Method to further add complexity to an already intricate model.

The treatment of non-linearity in Sensitivity Based Approach appears to have taken direction into the consideration of Vega and Curvature as inputs. Despite this, the use of a scenario-type approach (making use of spot-vol matrices) still appeals very much to us. We believe that the existing data availability and use of this risk measure in our existing risk management framework greatly supports the simplicity that is required under a Standardised Model. The treatment of Vega and Curvature also requires further development, most significantly from a data extraction, especially when considering the treatment of indices, which should be considered both in terms of considering the balance between simplicity and risk sensitivity as well as timelines for implementation.

We have to express concern regarding the increased complexity introduced by the Sensitivity Based Approach, and whether smaller banks with less sophisticated systems will be able to conform adequately to this model. It may be argued that these banks would be shielded against the full extent of the newly introduced complexity, since they typically trade in fewer asset classes and the trading is kept mostly to vanilla type activities. At the same time, the granularity of data required will still put notable strain on these banks.

5. **Conclusion**

We believe the Committee's timetable is ambitious, but achievable. Whilst we are not in favour of postponing much needed regulatory reform, we believe that given the extent of the changes, it will be prudent to allow for more Quantitative Impact Studies. This will not only provide a platform for optimum calibration between models but also ensure adequate preparation in terms of operationally stable systems.

We hope that our comments have added value to your deliberations.

Should you require any further information, please do not hesitate to contact me.

Yours faithfully



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