

June 20, 2018

Basel Committee on Banking Supervision
<https://www.bis.org/bcbs/commentupload.htm>

Dear Sir/Madam:

Re: CBA Comments on BCBS Consultative Document “Revisions to the minimum capital requirements for market risk”

The Canadian Bankers Association (CBA¹) is pleased to provide its comments on the BCBS consultative document “Revisions to the minimum capital requirements for market risk”. We are pleased that the BCBS has proposed further revisions to the standard in response to specific outstanding issues.

Our detailed comments on these proposed revisions are set out below.

Standardized Approach

Treatment of ETFs and Indices

The CBA welcomes the consultative document’s recognition that the treatment of index funds and ETFs is unclear and requires redress. After thorough analysis, we would like to express our concerns about elements in paragraph 69.

The proposed changes in the consultative document do not allow a flexible approach to the decomposition of the delta risk charge associated with index instruments and multi-underlying options, while this flexibility exists for vega and curvature. Required decomposition of delta risk charges imposes a significant burden on banks without improving regulatory oversight of capital market activities.

The CBA proposes that decomposing delta risk charge be optional, allowing banks to decompose or, alternatively, assign the risk to a conservative bucket/set of buckets. This flexibility would address the following industry concerns:

¹ The Canadian Bankers Association is the voice of more than 60 domestic and foreign banks that help drive Canada’s economic growth and prosperity. The CBA advocates for public policies that contribute to a sound, thriving banking system to ensure Canadians can succeed in their financial goals. www.cba.ca.

- increased reference data requirements and system capabilities can make the look-through prohibitive;
- more complex treatment (e.g., look-through) is not warranted for less material exposures; and,
- best practices in risk management may not always be consistent with look-through for an index.

Moreover, given the similar nature of the instruments and decomposition difficulties for some equity funds (e.g., ETFs, mutual funds), applying rules prescribed in paragraph 69 and recommendations made here would allow banks to capture risks in a consistent fashion.

Treatment of Multi-underlying Options

Canadian banks welcome the proposed amendment to paragraph 70 (Annex A.4), specifically the removal of 70a which exempted multi-underlying options with delta of different signs from delta and vega risk charge.

Guidance on Residual Risk Add-On

In the case of an investment in a fund, the consultative document states that such funds, which are looked through as if they were the tracked benchmark (using the new rule in paragraph 15a), would be subject to residual risk add-on (RRAO) if any of its constituents were subject to vega or curvature risk. Moreover, the fund as a whole would be subject to RRAO.

For example, if the fixed income benchmark tracked by a fund contained a callable bond subject to RRAO, the entire value of the fund would be subject to the RRAO. If this same fund were hedged with the underlying instruments, only the callable bond would be subject to RRAO amongst the hedges, and the hedged position would be subject to a net RRAO charge.

In the case where the benchmark consisted of all linear products except for exposure to a single vanilla option, the entire fund would be subject to RRAO, whereas none of the constituents would be.

In order to avoid situations such as these, we believe a better solution would be for the RRAO to only be applicable where a constituent in the benchmark would be subject to RRAO, as opposed to having vega or curvature risk as the condition, and for the RRAO charge to only be applicable to the portion of the fund's notional due to such constituents.

FX Asymmetry/Double-Counting

In order to address double-counting in FX curvature, the BCBS has proposed to allow banks to divide the curvature charges from instruments where none of the underlying currencies were the reporting currency by a scalar [X]. While Canadian banks appreciate this proposal, the required value of this scalar X can vary by individual portfolio. The required scalar to eliminate the double-counting varies significantly among Canadian banks, ranging from 1 to 2. Further, as this required scalar is dependent on the exact portfolio makeup, it would not be stable through time.

FX asymmetry is a significant concern as Canadian banks found that curvature charges computed from a CAD perspective were higher by up to 40% relative to those computed from a

USD perspective. Hence, in order to have a level playing field amongst jurisdictions, our proposal (consistent with ISDA's proposal) is to amend the standard as follows:

“banks are allowed to calculate their FX delta or curvature charges using the prescribed FRTB rules for an alternative currency, and capturing the translation to the reporting currency”.

Treatment of Precious Metals

While not an issue raised in the consultative document, the market risk text defines the commodity risk factor as spot prices, and forward or future prices with a tenor. In the precious metals (PM) market, forward contracts are commonly quoted with a lease rate and trade like FX instruments. It is industry practice to manage PM risk through lease rate sensitivities. In order to align with the market risk definition, each bank needs to build a PM forward curve from lease rates, and calculate sensitivities on a forward curve, which as noted deviates from how PM risk sensitivities are typically monitored and risk managed.

As such, we request that clarification be provided so that banks would have the option to decompose PM futures and forwards to spot and lease rate exposures. Regarding the treatment of lease rate exposures, we request consideration of the following two proposals:

1. Classify lease rates as a GIRR risk factor.

- Lease rate exposures by metal would be aggregated with other GIRR exposures.

2. Define lease rate as a commodities risk factor.

- Lease rate exposures would be defined as a separate delta risk factor with a risk weight of 0.2% (for PM, which is 20%/100).
- This proposal is analogous to the current treatment in equities, where spot and repo rate exposures are classified as separate delta risk factors which are correlated to a single delta charge (equity repo risk weight = equity spot risk weight/100).

FX Rates in Delta and Curvature Risk

The BCBS added a description in the consultative document as to how FX rates should be represented for FX Delta and Curvature risk. Specifically, paragraph 67(g) on page 17 states:

“ FX_k is the exchange rate between currency k and the reporting currency, expressed using the convention: units of “other currency” per unit of “reporting currency”.”

Broadly, it is a risk management practice to define shocks against assets expressed in the reporting currency. That allows for consistency across asset classes (e.g., 1% shock is against the value of equity in CAD or another currency in CAD).

Due to the manner in which the FX Delta and FX Curvature charges are specified in the SBA, the FX risk factors should be defined in a consistent manner with other asset classes. Thus, we propose amending paragraph 67(g) as follows:

“ FX_k is the exchange rate between currency k and the reporting currency that converts foreign currency holdings into a value expressed in the reporting currency: units of “reporting currency” per unit of “other currency”.

Internal Models Approach

P&L Attribution Test:

Data Alignment (Annex B.1 183(b))

CBA members agree with the proposed rule change to allow banks to align input market data to calculate HPL and RTPL for the PLA test. We view the purpose of this test only as a test of valuation methodology consistency and risk factor coverage; therefore, aligning input market data eliminates market data noise and allows the PLA test to better serve its intended purposes.

Test Metrics and Thresholds (2.1.2 Box 2)

CBA members agree that the proposed PLA tests are an improvement to the current test metrics. We find the Chi-squared version of the test easier to implement, easier to explain, and has less chance of rejecting performing models, a matter of concern to us, and yet still powerful in identifying bad models. We believe that the Chi-squared version of the proposed tests is more suitable for the industry.

However, we remain concerned over the proposed threshold levels of both the Chi-squared and the Spearman correlation tests and request the BCBS undertake additional QIS over the next two years before finalizing the thresholds. This will allow banks to stabilize their desk structures and harmonize their RTPL and HPL calculations further to provide more reliable data for setting the thresholds.

Test Frequency and Sample Size (Annex B.1 183(b))

The CBA endorses the change to conduct the PLA tests on a quarterly basis with increased sample size from 1 month to 12 months.

Valuation Adjustments (Annex B.5)

CBA members find the handling of valuation adjustments (VAs) in the framework overall to be problematic. The BCBS is using a combination of principles and explicit referencing to deal with exceptions in the HPL case. For instance, the following are removed from HPL: (1) fees and commissions, (2) intraday trading and new/modified deals, (3) XVAs, (4) VAs not calculated daily, and (5) bid-ask spread adjustments. The removals appear somewhat arbitrary. We suggest adopting a principles-based approach to including/excluding VAs in general, and allowing banks to coordinate the final list with their national supervisor.

Moreover, it is now also suggested that VAs not calculated at the trading desk level must still be included in firm-wide backtesting. However, applying firm-wide VAs is only appropriate if all desks have IMA approval. Otherwise, the bank will be comparing VaR on a subset of desks with VA P&L generated from across the firm. This may result in inappropriately increasing the likelihood of backtesting failures. For this reason, we suggest removing this requirement.

Risk Factor Proxies (Annex D.1 Principle 6 & Principle 7)

Principle 6 states that risk factors which are included in the current set but not in the reduced set must be proxied (i.e., mapped) to the most suitable risk factor of the reduced set for the purposes of calculating ES measures in the stressed period.

Principle 7 suggests that the use of proxies must be limited. If proxy data is used in the ES model, then either the proxy data is used for PLA testing or the bank must capitalize the basis between the proxy and the actual risk factor as a NMRF.

From the CBA's perspective, there are two general cases for proxying: (1) the data is not available in either the stress or current period and therefore needs to be proxied in both, and (2) the data is not available in the stress period but is available in the current period and meets the modellability criteria. We believe Principle 6 applies to both cases and would require banks to proxy in the stress period based on the reduced set of risk factors.

However, Principle 7 should only apply to case (1) as NMRF and modellability is really a current period concept (i.e., banks do not assign modellability based on stress period data). In this case, Principle 7 should be rephrased to clearly apply to only those proxies that occur in the current period. We suggest amending the wording slightly in Principle 7: "If risk factors are represented by proxy data in the current period ES model, the proxy data representation of the risk factor..."

Non-Modellable Risk Factors:

Market Data Observability (Annex B.2 183(c))

CBA members agree with the expansion of the definition of "real" price, specifically the allowance for an institution's own quotes to be used as evidence, subject to independent verification. We also agree with the added comments related to connecting "real" price observations to simulated risk factors, in that the onus is on the institution to demonstrate that "real" prices used to assess risk factor modellability are representative of those risk factors. In addition, we agree that the market data used to calibrate the model does not need to be the same as that used to assess modellability, given practical considerations such as data snap times.

Eligibility Test Risk Factor Bucketing (Annex B.2 183(c))

CBA members strongly support *Alternative 2* using a minimum set of regulatory prescribed buckets for risk factors, with the possibility of reducing further the minimum standardized bucketing structure for volatility surfaces to account for modeling dynamics. Standardizing on a minimum set of buckets across all banks will promote effective data collection across the industry and enhance comparability of results between banks.

Expected Shortfall Capital Charge:

Reduced vs. Full Risk Factor Set (Annex D.1 Principle 6)

The prior understanding by most banks was that risk factors not included in the reduced set would essentially be held static in both the $ES_{R,S}$ and $ES_{R,C}$ calculations. Principle 6 (page 32) now appears to stipulate that risk factors that were not intended to be included in the reduced set will now need to be mapped to the most suitable risk factors in the reduced set, implying that there is no longer an option to hold these risk factors static. We request the BCBS confirm that this is, in fact, the intention of the rule. If so, we further request confirmation of whether the proxy mapping must be consistent in both $ES_{R,S}$ and $ES_{R,C}$ even though the risk factor may exist in the current period.

Backtesting:

Risk Factor Backtesting (Annex D.2 Example 4)

Example 4 (page 33) introduces the requirement for backtesting risk factors directly or backtesting hypothetical portfolios highlighting specific products. It is unclear whether these backtests would be held to the same criteria as the actual and hypothetical P&L backtesting. The suggestion for hypothetical portfolios is also unclear and will certainly lead to consistency issues between banks. CBA members suggest the BCBS provide an option for banks to replace this requirement by adding risk theoretical P&L backtesting to the backtesting program. This will essentially capture risk factor modeling, pricing models and risk factor correlations in a more direct way and avoid banks having to set up entirely different backtesting frameworks.

Trading/Banking Book Boundary

Equity Investments in a Fund

Paragraph 15a of the consultation paper provided clarity as to when equity investments in a fund can be included in the trading book. In order to do so, the following criteria must be met:

- have daily price quotes
- track a non-leveraged benchmark (allowing full look-through)
- have an absolute value of a tracking difference, ignoring fees and commissions, of less than 1%.

Consistent with the ISDA view, we believe trading intent should remain as the key determinant for classification of equity investments in a fund. The CBA believes that trading book treatment is appropriate for a desk that is making markets and satisfying client demand for equity investments in a fund, including, but not limited to, ETFs and mutual funds.

ETFs are created to satisfy client demand to easily obtain access to a particular asset class/sector/trading strategy. Banks, as market-makers, are willing to make markets for clients in ETFs, mutual funds, or derivatives in these products. However, the majority of Canadian ETFs do not publicly disclose their composition baskets on a daily basis, although a bank may be willing to make markets with clients on the ETF. In most cases, the daily composition is only disclosed to Authorized Participants (parties engaged in the creation or redemption of the funds)

or to the Designated Broker. This would prevent some participants, including some market makers in these products, from having a full look-through of the fund.

In addition, for derivatives on mutual funds, while the fund itself may not always have a daily “look-through”, it would have a daily NAV. Our understanding is that the NAV is executable and can be viewed as a real price.

As such, the CBA believes that equity investments in a fund that satisfy the trading purposes listed in paragraph 12 should be assigned to the trading book provided they meet at least one of the following conditions: daily prices or full look-through. This would be consistent with the draft CRR text for European regulations. It also allows trading book treatment to align better with how the funds are risk managed. Forcing funds that are held for trading purposes into the banking book could restrict market making activity in the market and limit client access to funds.

Repos

The consultative document provided some additional wording in a footnote in paragraph 16 to further define the meaning of trading-related repo style transactions. That is, “Repo-style transactions that are i) entered into liquidity management and ii) valued at accrual for accounting purposes are not part of the presumptive list of paragraph 16.”

The CBA believes that in the majority of cases repo style transactions satisfy the first condition, namely that they are entered into for liquidity management purposes, and that this informs the decision on accounting treatment. As the definition of liquidity management is subjective, the CBA would like to propose that the classification of repos be based on how the transaction is valued for accounting purposes. This definition avoids unintended inconsistencies or deviation from accounting compliance. For example, if a repo-style transaction is accrual for accounting purposes but was determined not to be for liquidity management, the position would be trading book under FRTB and forced into MTM through P&L. The accounting definition also has the advantage of being unambiguous and can be consistently applied across banks leading to more comparable interpretations and results. Further, the CBA is also concerned about the operational aspects of bifurcating certain repo activity between the trading and banking books as this is not consistent with current business activity since repo collateral is managed in aggregate across the business.

Trading Intent & Potential Conflicts Between Paragraphs

The consultative document provided clarity around potential conflicts between paragraphs. In particular, it has clarified that the presumptive banking book list in paragraph 15 is mandatory and takes precedence over paragraphs 12, 13, and 16.

While Canadian banks are clear on the interpretation of the rule, we are supportive of ISDA’s efforts for a more flexible framework by removing the absolute prevalence of presumptive lists and recommend the “trading intent” of instruments remain as the deciding factor for the trading book/banking book classification.

PLA and Backtesting Framework at the Trading Desk Level

The consultative document added that “Both actual and hypothetical P&Ls include FX and commodities in the banking book if their regulatory capital is calculated using an internal model”. The definition of Actual P&L in the Glossary has also been expanded to emphasize that the actual P&L and HPL should include FX and commodity positions held in the banking book.

Given actual P&Ls are typically not produced for banking book instruments (accrual accounting), it is unclear how banks would be able to produce actual P&Ls including FX and commodities in the banking book. A similar concern was raised by ISDA/AFME in response to the EBA's Discussion Paper on EU implementation of the revised market and counterparty credit risk frameworks (December 2017)².

The CBA agrees with the comments raised by ISDA and AFME on this topic and supports ISDA/AFME's proposal to exclude non-FV positions from backtesting and P&L attribution requirements, or more broadly to remove the quantitative requirements for the internal models approach for the notional desks from IMA notional trading desks.

Trading Desk Structure

The CBA appreciates the BCBS's suggested changes in Annex C that will permit an individual trader or head trader to work across two desks. In our view, however, a two-desk cap continues to be a material limitation relative to current organizational structures. Hence, we request the reference “two” be changed to “multiple” in Annex C (Paragraph 24 (a)) and in Key Element #1.

CBA members note that restricting a trader or a head trader to a maximum of two desks introduces unnecessary and material operational burden and increases the complexity and risks associated with running desks. These challenges are illustrated through examples in the Appendix.

In addition to these examples, Canadian banks will engage with Canada's regulator/supervisor, the Office of the Superintendent of Financial Institutions, on a bilateral basis if needed, to provide additional evidence indicating why restricting a trader and head trader to two desks imposes operational constraints that do not exist today.

We would be pleased to discuss these comments with you further at your convenience.

Sincerely,



² ISDA and AFME response to the EBA's Discussion Paper on EU implementation of the revised market and counterparty credit risk frameworks (page 22-25):
<https://www.afme.eu/globalassets/downloads/consultation-responses/afme-prd-isda-response-eba-rtf-paper-on-market-risk-and-counterparty-credit-risk-framework.pdf>

Attachment

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Appendix – Proposal Regarding Trader and Head Trader Desk Restrictions

Example 1

Banks should be permitted to allocate trading expertise across desks in a manner that optimizes decision making capabilities. For example, a trader with deep knowledge of credit markets trades on both a credit and a CVA desk. Similarly, a head trader may have oversight responsibilities for trading options (i.e., non-linear products) on commodities which cut across both precious metals and base metals desks. Thus, traders typically trade on (and head traders have supervisory responsibilities for) multiple desks that have similar strategies. The inability to allocate traders and head traders according to business needs deprives desks from valuable expertise and knowledge, thereby potentially decreasing decision-making quality and increasing risk. Furthermore, banks will be required to hire additional traders and head traders to get sufficient coverage under FRTB. These new hires will need to have the same competencies as experienced traders that have honed their skills trading across multiple desks, and such resources may not be readily available.

Example 2(a)

Traders are sometimes required to book trades into multiple desks for practical and operational reasons. In some FX businesses, for example, the same trader could be assigned to multiple desks (even across different geographies and time zones) as the FX market trades 24/7. Restricting a trader's ability to book trades to just two desks will disrupt trade booking practices with no obvious improvement to risk management or compliance.

Example 2(b)

Additionally, it is common for traders to be assigned to multiple desks for back-up and/or redundancy purposes (e.g., vacation coverage). This is especially applicable for smaller desks. Maintaining the trader-to-desk restriction to a maximum of two desks would result in significant inefficiencies in the assignment of traders, and the possibility of having to hire additional staff solely for back-up purposes.

Example 3

Traders are commonly assigned to more than one desk to facilitate client transactions across all geographical regions (e.g., Europe, Asia, etc.). This concern is of particular importance to regional desks. For example, regional desks at some Canadian banks employ “generalist” traders that trade multiple products across different asset classes including FX, interest rate products, equities, and commodities to facilitate client transactions and support demands of the domestic client base. Keeping the trader-to-desk restriction to a maximum of two desks will adversely affect the ability of Canadian banks to provide liquidity and access to foreign markets to Canadian clients.