CREDIT SUISSE

CREDIT SUISSE
Eleven Madison Avenue
New York, NY 10010-3629

Tel 1 212 325 2000
www.credit-suisse.com

CREDIT SUISSE GROUP AG
Paradeplatz 8
P.O. Box
CH-8022 Zürich
Switzerland

Phone +41 44 333 11 11
Fax +41 44 332 55 55
www.credit-suisse.com

Stefan Ingves
Chairman Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, Switzerland
Sent by email to: baselcommittee@bis.org

20th February 2015

Re: Credit Suisse Response to the BCBS Consultative paper on the Outstanding Issues with regard to the Fundamental Review of the Trading Book (FRTB) capital standards – BCBS 305.

Dear Chairman Ingves,

Credit Suisse Group AG (CS) would like to thank the Basel Committee on Banking Supervision (Committee) for the opportunity to comment on the third consultative document: "Outstanding Issues with regard to the Fundamental Review of the Trading Book (FRTB) capital standards", BCBS 305. We remain fully supportive of the FRTB's overall objective to enhance the market risk framework.

CS has found the recent interactive approach and dialogue with the Trading Book Group (TBG) of the BCBS, constructive and highly effective in driving forward joint proposals which assist the TBG in achieving its framework objectives. We urge the BCBS to continue its strong engagement with the industry to ensure that the final rules text is appropriately risk sensitive, reasonable to implement and meets the objectives of the Basel Committee.

CS played an active role in, and fully supports, the joint responses to the consultative paper provided by International Institute for Finance (IIF), the Global Financial Markets Association (GFMA) and the International Swaps and Derivatives Association, Inc. (ISDA) to the TBG. In this response we would like to take the opportunity to highlight a subset of issues that we consider the most significant across the piece:

1. Standard rules: Curvature
   The cost of businesses risk managing large price movements will increase as the rules restrict the gamma benefit of hedging. This will result in higher market making costs and reduced liquidity.
2. Standard rules: Asymmetric correlations
   CS recommends the removal of asymmetric correlations as they add significant complexity relative to the benefit they bring.

3. Model Eligibility
   CS welcomes the further development and strengthening of the internal model eligibility testing framework. We urge the Committee carefully consider if on balance the current eligibility tests achieve their desired outcome, and reiterate our willingness to assist the TBG.
4. IMA: Liquidity Horizons
   CS recommends that the committee adopt proposals to calibrate an adjustment to longer liquidity horizons to take into account mean reversion, and more closely reflect real world observations.
5. IMA: Real Price Data and Non-Modellable Risk Factors (NMRF)
   CS urges the committee to engage with the industry to reach an achievable definition of real price data, since the current rules could severely limit the risk deemed modellable.

Finally, we would like to take the opportunity to signal our high level concerns on the potential impacts of the final rules. We fully recognise that the Quantitative Impact Study (QIS) conducted in June 2014 was based on a draft framework, and that the calibration phase has yet to begin. Nevertheless, there was a very significant observable increase in capital requirements, which creates concerns around end-state trading book capital constraints. In particular, we note that conservatism has been built into aggregation assumptions at a granular level, and that could be hard to dial back to a more proportionate level via calibration alone. We encourage the Committee not to declare the framework final until after a holistic QIS has demonstrated the impact on trading book capital levels across the industry, and the implications have been considered fully. We would also recommend that pass-through impacts on the cost of end-user hedging and the effects on high yield SME lending are considered.

FRTB changes are not happening in isolation, but in parallel with a major overhaul of regulatory capital across multiple different dimensions. Arguably, impacts of reforms like the FRTB will be concentrated in some of the largest providers of liquidity to the market. The potential systemic risk, as well as the micro prudential challenges to firms as they seek to implement, will be best mitigated by holistic analysis, continued positive engagement with the industry, and a more realistic timeframe.

We reiterate our overall support for the objectives of the FRTB, and we stand ready to assist the TBG in whichever way we can to facilitate finalisation of the framework.

Yours sincerely

Dan Miller
Head of Market Risk Management

Detail of the most material issues:

1. SBA – Curvature

The sensitivity based approach applies conservative netting in the curvature treatment; in particular, the approach severely restricts offsets between delta and positive gamma. Many trading desks use option strategies to mitigate losses due to adverse market moves. This is a key part of the risk management toolkit, and recognition of it in the capital framework, should be seen as strength and not a weakness. Restricting the aggregation of positive gamma against delta will materially increase the costs of risk management, resulting in higher market making costs, and reduced liquidity.

Under the current proposals, delta and gamma are calculated separately, leading to the possibility that they are capitalised under mutually exclusive scenarios. This deviates from economic reality and should be avoided within the framework, even if resolving it requires some additional complexity.

Recommendation: CS supports a framework which does not increase the costs of active risk management, and urges the committee to work with CS and the rest of the industry to develop an approach which cannot lead to the capitalisation of mutually exclusive scenarios.

2. SBA – Asymmetric Correlations

CS understands the concerns of the Committee around the uncertainty of correlations. However, CS believes there can only be a single correlation between two risk factors. Introducing asymmetric correlations in order to increase conservatism around the absolute level of correlation is overly complex and leads to unintended and non-risk sensitive outcomes. CS would prefer a simpler methodology, using single pairwise correlations, giving more risk sensitive results.

Recommendation: CS recommends the removal of asymmetric correlations as they add significant complexity disproportionate to the benefit they bring.

3. Model Eligibility

CS welcomes the further development and strengthening of the internal model eligibility testing framework, as well as the ability to understand the drivers of model performance at a more detailed level. We note, however, that the details of these new metrics will need to be carefully calibrated to accurately identify poorly performing models, and strongly recommend that the BCBS gather and analyse data from multiple QIS, run over a range of market conditions, before finalizing the form and parameters of the tests around this. CS would be happy to assist the TBG in the design and calibration of this, in the period between now and go-live of the Fundamental Review.

The definition of the P&L Attribution test has a number of aspects which lack clarity. Additionally there is some concern about the test's suitability given it is possible to fail models which are conservative. Historically conservative approaches have made adequate capital measures, so there is concern that the test could lead to inappropriate failures.

The Model Independent Risk Assessment Tool (MIRAT) (a leverage ratio) may not prove to add significant value. The assessment of appropriate leverage at desk level is not trivial, since different products and businesses will inherently have different levels of leverage depending on the product mix and portfolio composition. This exercise becomes more difficult when applied across the industry, due to the variation in how desks are structured within different banks. Desks focused on low risk lending to high quality counterparties will have high leverage, and therefore a low ratio of RWA to exposure. This does not necessarily infer the capital model is incorrect. The use of the MIRAT test may not identify poorly performing models accurately.

Recommendation: CS recommends that the BCBS gather and analyse data from multiple QIS, run over a range of market conditions, and not only assess the calibration but also if on balance the whether the current or revised eligibility tests achieve their desired outcome before finalising their inclusion in the framework.

4. IMA – Real Price Data and Non-Modellable Risk Factors (NMRF)

CS supports the objective of the TBG to provide incentives for banks to improve data quality and minimize the risk factors that would fall under the NMRF definition. However, as discussed at the Industry-TBG meeting on the 15th January 2015, we strongly urge the TBG's consideration of the industry's proposals on non-modellable risk factors. Furthermore, we welcome the opportunity to work towards a more practical set of principles, constraints and capital charges which would result in global standards which are more similar to current RNIV approaches.

Recommendation: CS urges the committee to engage with CS and the industry to reach an achievable definition of real price data, since the current rules are unworkable and could severely limit the risk which is deemed modellable.

5. IMA – Liquidity Horizons

CS welcomes the revisions and clarifications made by the committee in the third consultation paper. In particular, the use of a scaled 10-day ES is a pragmatic approach to the incorporation of variable liquidity horizons and resolves pricing issues associated with incompatible risk factor shocks. CS recognises that the refinements introduced within CP3 represent a step in the right direction, resolving the length of Liquidity Horizons for more liquid IR and FX, as well as the measure to address the "broken hedge" issue.

The QIS highlighted a problem with the approach of scaling 10 day ES results using the square root time adjustment, namely the empirical observation of mean reversion. This effect means that the current adjustment for liquidity horizons longer than 90 days is overstated. CS recommends the BCBS adopt industry proposals around the adjustment of the scalar for longer liquidity horizons.

Currently high yield debt has a 120 day liquidity horizon. CS questions the macro economic implications of increasing capital requirements against non-investment grade lending so materially.

The implications of this would be anticipated to impact small and medium sized companies hardest, both in terms of costs and more prominently the liquidity of market making activities. However, adopting reduced scalars based on empirically observed mean reversion would reduce the negative impact.

Separately, CS requests that the final rules text includes an option to calculate a full P&L strip at the given liquidity horizons as outlined in CP2 [BCBS 265, Annex 1, Section D, 181]. This will enable banks to continue to improve the accuracy of their models as their full revaluation capability improves.

Recommendation: CS recommends that the committee adopt proposals to calibrate an adjustment to longer liquidity horizons to take into account mean reversion, and more closely reflect real world observations.

Detail of other material issues:

Quantitative Impact Study (QIS)

CS would like to thank the BCBS for their engagement and timely responses to the 2014 year end QIS FAQ process. The QIS process is integral in informing the design and calibration of the framework. As such CS strongly advocates the consideration of a further QIS based on June 2015 data prior to finalisation of the rules. Moreover, since the capital impacts as part of the last QIS exercise were so material, CS believes it would be prudent to delay a complete finalisation of the rules until after a holistic QIS can be completed, and the Basel committee have considered the implications on trading book capital levels across the industry. In order to avoid any delays in the overall implementation time, CS propose that refinement of the framework be possible during the calibration phase.

Trading Book/Banking Book Boundary

CS appreciates the efforts by the BCBS to clarify the boundary definition and support the overall objective of ensuring exposures are capitalised by the appropriate frameworks. CS supports the continued use of the intent-based rule. The addition of the presumptive list for trading book instruments is welcomed for the added clarity, however, we recommend that the committee make the banking book instrument list presumptive too, thereby avoiding potential conflicts between this list and the intent-based rule. Permitting this flexibility will allow banks to manage their risks in the most effective manner whilst still giving supervisors oversight and control to ensure appropriate behaviour.

Internal Risk Transfers

CS has concerns around the two options put forward by the committee for the management of internal risk transfers (IRT) for GIRR. Both options prohibit the management of GIRR in the trading book, arising from IRTs, on a holistic basis. This is inefficient for both the bank and the market leading to increased trade volumes and counterparty credit risk throughout the system, for no economic benefit, as banks are forced to hedge these risks on a gross, rather than net basis. CS supports the industry view that GIRR is best managed holistically by the appropriate desks mandated within the bank. Any concerns around capital arbitrage can be met by transparent disclosure of IRTs without the additional complexity arising from the proposals in the consultation document.

The Revised Standardized Framework

Disallowance Factor: CS strongly supports the committee's decision to remove Disallowance within the SBA framework

Computation of IDR

CS supports the comments raised by the industry in the January 15th presentation, in particular:

- The use of 3bp floor is overly conservative and is not justified by empirical evidence and is potentially damaging to the market-making of sovereign debt
- The request for the TBG to consider the inclusion of all equity exposures in the IDR
- CS welcomes the use of credit spread data to estimate default correlations where sufficient equity price data is not available

In addition to the points raised by the industry CS would like to seek clarification on how defaulted debt should be included in the calculation of IDR?

CP3 Questions:

Q1. What are your views on the specific refinements described in the three sections of this consultative document?

Aside from the specific comments made above and in the joint response letter, CS recognises that progress in the third paper is sizable and moving in the correct direction. The primary concern remains the ability to resolve all outstanding issues within the remaining timeframe.

Q2. Do these specific proposals strike the right balance between simplicity, comparability and risk sensitivity?

CS supports the introduction of a risk sensitive standardised approach. However, in order to provide a credible fall back to internal models, it is important that the approach strikes the right balance between simplicity and complexity, i.e. simple enough for all banks to apply but requires a level of complexity sufficient to capture all material risks.

CS believes that in certain areas simplicity and risk sensitivity have been sacrificed to introduce conservatism at the granular level. For example, it would be far simpler and more risk sensitive to remove asymmetric correlations from the aggregation of SBA. CS believes that the sensitivity based standard rules model, should fundamentally reflect real world economics, with any perceived requirement for conservatism being built in at a higher level.

Recommendation: Removing certain elements of complexity would increase risk sensitivity and improve simplicity. We advocate changes to elements where this is the case.