European Association of Public Banks

– European Association of Public Banks and Funding Agencies AISBL –

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EAPB comments on the Basel Committee's consultation on "Guidelines for computing capital for incremental risk in the trading book" and "Revisions to the Basel II market risk framework"

The EAPB is grateful for the opportunity to comment of the two consultation papers "Revisions to the Basel II market risk framework" (CP 148) and "Guidelines for computing capital for incremental risk in the trading book" (CP 149). We would like to provide our response in the following.

Before we comment on the changes presented in the two papers in detail, we would like to start with a few basic comments.

A. General comments

Unintended side-effects

Against the background of the most recent financial market turbulences, we can in principle understand the efforts made by the regulatory authorities to increase capital requirements in order to cover market risks and additional risks in the trading book. However, in the future, capital requirements should also be in line with risks assumed by the banks. From the point of view of the credit services sector, comprehensive efforts are already being made in broad areas of internal risk management to counteract the causes and effects of the financial market crisis. We are of the opinion that a revision of a bank's specific situation has clear advantages over a global increase of own funds prescribed by regulators.

Furthermore, a synchronised balance between the models used internally by banks in future and the regulatory requirements ("use test") should be ensured. The (further) development of models must not be restricted by rigid regulatory requirements, particularly in the area of measuring incremental risks, for which no market standards currently exist. Banks prefer to

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implement risk models, as these are more flexible and appropriate for their individual risk profile and portfolio configuration. With inflexible regulatory model requirements, which are primarily conservative in nature, the advantages of an internal model will be lost. The incentive of risk control on the basis of a bank-specific model would therefore be significantly reduced. In this respect, we still have doubts about whether it is possible to fulfil the use-test requirements on the basis of the specifications in the third consultation paper.

Assessments by the credit services sector show that the proposed regulatory requirements for the modelling of incremental risks and the introduction of the stress VaR would result in a huge in-crease in capital charges for the trading book, irrespective of the portfolio. This multiplication of the capital charges would also lead to secondary effects. According to our assessment, the capital-orientated incentive of transferring from market risk standard procedures to model procedures will thus be negated by the increasing capital charges for the latter method. This will make internal further development and the regulatory use of risk models unattractive.

This would also result in an incentive to not include and manage risk positions in the trading book but to allocate these to the banking book wherever possible. This is particularly evident in the example of securitisation positions: Our understanding of Item 38 is that the capital charges for securitisations in the trading book must effectively be determined on the basis of the banking book regulations. However, as such items are also to be taken into account in the standard VaR general market risk (must rule) and, if applicable, in the standard VaR specific risk (can rule) and the stress VaR (must) for the capital requirements, apparently desired arbitrage incentives arise which benefit the banking book.

A lack of incentives for trading book activities does not only have an effect on the bank itself. In general, the development of these incentives could lead to fewer market participants with the consequence that higher margins could be imposed in less liquid markets, thus increasing the costs for many financial service providers. The distortions in the market lead to arbitrage opportunities, which could have a negative effect on market prices.

Time schedule

We welcome the extension of the implementation deadline compared to the second consultation paper. We would nevertheless like to draw the attention of the Basel Committee to the differences in terms of content and deadlines between the Basel provisions on the one hand and the currently valid European and national regulations for the management of incremental risks on the other hand. This uncertainty regarding how national regulators will handle discrepancies must not result in any disadvantages for the banks. At the same time,

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the extension of the implementation deadline should also be made use of in order to complete the discussions still to be held without excessive time pressure and with the appropriate care.

Hasty decisions must be avoided at all costs due to the comprehensive internal model adjustments.

B. Comments on the paper "Revisions to the Basel II market risk framework"

1. Chapter II: Implementation date

We generally welcome the extension of the implementation deadline to 31 December 2010. The Basel Committee should avoid making rash decisions in light of the considerable quantitative effects of the proposals. Following the execution of the planned impact study in spring this year, a new consultation should take place with the credit services sector in order to take the produced data into consideration before the paper is finalised.

2. Chapter III: Changes to the standardised approach for market risk

The definition of the term "re-securitisation" and the increased risk weighting for re-securitisation correspond to those of the banking book. The definition of re-securitisations in particular will be rejected in its current form by the credit services sector within the scope of the consultation regarding the consultation paper "Proposed enhancements to the Basel II framework". We kindly ask you to also take these comments, still to come, into account for the trading book regulation.

We also continue to consider the intended increase of the capital requirements for specific exchange rate risks of equities to a flat rate of 8 % to be inappropriate. The capital securitisation for specific risks should continue to be aligned with the diversification of the portfolio. The financial crisis has shown that although volatility has increased for almost all financial instruments, the risks for diversified portfolios are sill significantly lower than those of an undiversified portfolio. We therefore consider it to be absolutely necessary to leave Item 718 (xxi) unaltered.

3. Chapter IV: Changes to the internal model approach to market risk

Quantitative standards

We welcome the fact that, despite initial considerations of the Basel Committee, the possibility of scaling a 1-day VaR to a 10-day VaR using the square root t-rule will remain in

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existence. If this option were to be removed, this would lead to further considerable disadvantages for the banks.

However, we believe that the described quantitative standards still overshoot the target by a considerable extent. We are in particular concerned about the danger of incorrect control impulses being set, which would compromise the performance of internal risk management and regulatory requirements. The guidelines for the determination of the stress VaRs will play a considerable role when ascertaining capital requirements in the future and, by design, will be significantly higher than the capital requirements for the standard VaR. This means that the importance of the standard VaR approach for capital control purposes will be weakened.

In addition to this, the consultation paper strengthens the importance of stress tests for internal controls and regulatory monitoring, which is completely justified in our opinion. However, we are more critical of the selection of the relevant stress tests. Only concrete historical scenarios are applied for the stress test procedure and the determination of the stress VaR.

Many years of observing historical data have shown that even the "financial market crisis" scenario in 2007/2008 is not very meaningful in terms of predictions. Irrespective of the fact that both years were based on a very active capital market, much higher volatility was registered in previous years for both interest rates and equities. For example, the latest peak of interest rate volatility was in summer 2003. This makes it clear that any period, even when carefully selected, can only be of limited significance. At the same time, the question about "the" scenario cannot be answered. For this reason, a measured form of stress testing suitable for internal control should be applied to a range of scenarios. In doing so, all risk factors with their specific effect on stress for a portfolio and the stress potential from overall crisis situations should be taken into account. This is also recommended by the Basel Committee in the consultation paper "Principles for sound stress testing practices and supervision" (CP 147), which states that all relevant risk factors should be included along with their specific stress effects and the stress potential from overall situations. The complexity involved is, for example, one of the reasons why stress tests are so unsuitable as indicators for capital resources securitisation.

In our opinion, the actual purpose of stress tests should be adhered to, which is internal control and disclosure to third parties and regulators. Stress tests are, however, not appropriate for the determination of regulatory capital.

Another point to be highlighted is the authorisation to use weighted time series as long as the calculated risk is higher than in the unweighted case (footnote 11, page 11). The use of the maximum value therefore allows potential for faulty control impulses. The result is

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inappropriate for internal control and should therefore not be applied to capital charges of internal models.

The comment “for most portfolios, the Committee would consider a 12-month period relating to significant losses in 2007/2008 to be a period of stress” (page 12) would, in our opinion, restrict the margin of discretion at the banks too much. We assume that a bank can also select an individual 12-month dataset without providing detailed reasons. If individuality is not possible and the market dataset indeed only applies to the 2007/2008 crisis scenario, we ask that this be deleted.

Should the determination of the stress VaR be adhered to, we would like to draw attention to the following: The construction of the stress VaRs means that it is not possible for a situation to exist which can be regarded as being a “normal market situation” and as a “stressed market situation" at the same time. It would therefore be much more plausible and would lead to more realistic capital requirements if “stress VaR” and “standard VaR” were connected to a maximum condition rather than adding both.

According to the guidelines for determining the stress VaR, only the qualitative multiplication factor x and not the backtesting multiplication factor y is to be taken into account for the multiplicator. The context of justification for factor 3(+x+y) in normal market risk VaR as a factor for possibly existing model errors or model shortcomings cannot be transferred to the concept of stressed VaR. If the stress VaR is regarded as a further supplement for model shortcomings, the factor 3 appears to be unjustified at the model level as another conservative estimate for the determined VaR, which is already under stress. According to our assessment, the multiplicator should not be applied in the case of stress VaR.

Stress testing

Definite historical scenarios are emphasised in the scenario selection. In our opinion, these are not necessarily well-suited for the modelling of future stress situations. Future-orientated scenarios should rather be designed on the basis of historical experience in such a way that they will also work within the new market conditions. In this respect, the scenario selection should be applied in a much broader way than as a simple replication of historical events.

Treatment of specific risk

According to the IR modelling guidelines, it is possible for banks to avoid calculating an IR charge for equity risks, an IR modelling can be omitted. We welcome the opportunity to carry out the modelling of equity event risks within the scope of the specific market risk VaR. In

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this respect it is unclear which requirements have been established for the standard 10-day VaR model. Evidence that event risks (e.g. in the case of merger trading strategies) can be sufficiently recorded by these models would be very difficult to obtain in many cases. The requirements stated in this case must in particular not go so far that the modelling cannot be permitted and capital charges according to the market risk standard approach become necessary.

According to our understanding of the Basel guidelines for specific interest rate risks, event risks are also to be taken into consideration in the standard 10-day VaR models in this case. These event risks usually involve market risks resulting from migration events and which are to be taken into consideration within the IR modelling according to the guidelines in the third consultation paper. In order to avoid double counting, we do not think an event risk modelling should be required within the standard 10-day VaR framework.

Model validation standards

Already now situations can arise in which outliers can be identified in certain market situation for which the standard 10-day VaR is not intended. The outliers would not be counted in this case. This is particularly applicable if the outliers result in incremental risks on the basis of the manifestation. Although rating events are, for instance, contained in the IR modelling, they may lead to backtesting outliers and a resulting supposed worse prognosis quality of the standard VaR model. The hitherto room for manoeuvre of the regulators with regard to whether outliers should be included or not must not be constricted in the future. We kindly ask you to clarify this point.

We welcome the new guideline proposing that the quality of VaR models should be exclusively evaluated on the basis of a clean backtesting approach. Only the comparison of VaR estimation and clean P&L, but not the comparison of VaR estimations and dirty P&L, will lead to a reasonable evaluation of the model quality. As international banks have been able to carry out dirty backtesting with the permission of regulators in the past, but must submit clean P&L results in the future, it seems inconsistent that these results should not also be applied when counting the backtesting exceptions. Dirty backtesting on the basis of the dirty P&L will generally show a lower number of outliers than the corresponding clean backtesting, due to the usually positive profit sums contained here, which do not result from an assumption of risk. As the number of exceptions determines the backtesting multiplication factor, the use of the dirty P&L results would also lead to a tendency towards lower capital charges with significantly negative effects on the international competitive situation. A disclosure regarding the number of these exceptions will also take place under Pillar III, and the results therefore also have a significant public disclosure effect. The combination of outlier numbers on the basis of a clean backtesting with the figures from a dirty backtesting in the bank comparison, which cannot be avoided, would put the banks at a significant

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disadvantage with clean backtesting and cannot be justified. We therefore request that only the clean backtesting results be taken into consideration for competitive reasons, including when counting backtesting exceptions.

4. Chapter V: Changes to the supervisory review process for market risk

The future capital requirements will be extremely conservative, according to initial assessments. This results from the already conservative guidelines for individual summands, and also the fact that diversification effects e. g. between the risks contained in the standard VaR and the risks subject to an IR charge, are not taken into account due to the additive approach. Due to this situation, it appears to be impractical and unnecessary in particular for trading book positions to impose further add-ons under Pillar II.

5. Chapter VII: Treatment of illiquid positions

The Basel Committee refers to international accounting standards in its guidelines for the treatment of illiquid positions. In our opinion, there are therefore redundancies in the consultation paper statements regarding the existing accounting requirements of IAS 39 and those of the guidance paper "Measuring and disclosing the fair value of financial instruments in markets that are no longer active", issued by the IASB Expert Advisory Panel in October 2008. In terms of a consistent application and interpretation of the IRFS guidelines for the establishment of standards in international accounting, the International Accounting Standards Board (IASB) and, for the interpretation of the standards, the International Financial Reporting Interpretations Committee (IFRIC) are principally responsible. We request that Chapter VII be edited in such a way that it neither recommends an extension of the requirements for international accounting practice nor a limitation for those preparing balance sheets.

C. Comments on the "Guidelines for computing capital for incremental risk in the trading book"

1. Principles for calculating the IRC

IRC-covered positions and risks

During this financial crisis, the deficits in the trading book risks captured through internal models have made clear that an approach based exclusively on ratings is not able to adequately assess the particular risk factors of securitisations. It is therefore surprising that the Basel Committee now bases the calculation of capital requirements completely on external ratings. This would in particular be the wrong approach in the case of banks using

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internal models. In the light of the negative experiences during the financial crisis with external credit ratings issued by rating agencies, the question arises as to why the Basel Committee is not focussing more closely on the requirements of internal risk measurement processes.

We consider the removal of all securitisation positions from the calculation of the IR capital requirements to be undifferentiated and incorrect. Even if – as explained in Item 10 – securitisation positions could be regarded as hedge instruments, they may not be taken into account when determining the IR capital requirements. This artificially disrupts hedge correlations. We request the possibility to determine capital requirements on the basis of internal models for such positions. Insofar as there are doubts about how far a hedge correlation is stable in a "stressed market" situation, this issue could be resolved by creating a reasonable definition of the "hedge correlation".

In those cases where a hedge correlation does not exist, we also consider it to be excessive that such securitisation positions would generally not be permitted for the determination of the IR capital requirements on the basis of the internal model. Depending on the complexity of the respective securitisation structure, banks using models may well be in a position where they can adequately model many of these instruments internally. This will be even truer in the future, taking into account the efforts of the banks to improve the risk measurements of such instruments. These efforts should be encouraged by the regulators, not restricted. The extent to which reasonable modelling for securitisation positions are available can be monitored by the regulators at any time. In this respect, the banks should have the option of using their own modelling, specific to products and portfolios if applicable, if they are able to provide evidence that it is appropriate.

Finally, we ask for clarification that a possibly required removal of certain business for the calculation of the IR capital requirements does not essentially necessitate the removal of these positions from internal risk assessment on a model basis. This would diametrically contradict the character of the VaR as a portfolio approach and further increase the discrepancy between the IRC model and risk assessment on a model basis.

Constant level of risk over one-year capital horizon

We still consider the reference to the banking book guidelines in Basel II as a reference point and justification for the regulatory selection of a "one year capital horizon and 99.9 % confidence level" to be unjustifiable and not reconcilable with the reality of a trading environment. For economic risk control in banks, risk management strategies are used which are not consistent with the "constant level of risk over one-year capital horizon" assumption and should therefore be taken into account when calculating capital requirements. This would make the IRC significantly more risk-adequate and also provide incentives to further

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develop risk management. In this respect we also welcome the new regulation in Item 31. However, this possibility does not go far enough, as this only applies to "dynamic hedging strategies", which only make up a part of the conceivable risk management strategies.

Liquidity horizon

The determination of liquidity horizons in the context of securitisations is discussed in paragraphs 18 and 24. We therefore conclude that the Basel Committee has considered, as requested by us above, the possibility of continuing to include securitisations when determining IR positions.

The absolute lower limit for a three-month horizon appears to be significantly too high considering the fact that the IRC relates to trading book positions. This is particularly true as the Committee is primarily geared to a stress situation ("… liquidity in many parts of the securitisation markets dried up ..." page 4). The banks themselves should in fact be responsible for determining reasonable liquidity horizons for the respective positions. The establishment of a three-month floor prevents the reasonable consideration of the different market situations. Should the regulators decide not to give banks responsibility for determining the liquidity horizons, we request that there be an even more conservative floor of only one month, as there are many positions for which a floor of three months would be too long, such as positions which have a short remaining time until maturity. Three months is also too long for most credit products and "single name and index CDS".

We still assume that it is possible to adopt a standard liquidity horizon for all instruments ("… appropriate liquidity horizon for a position or set of position ...," page 4) as long as the floor conditions have been fulfilled. We kindly ask you for clarification.

Correlations and diversification

The Committee has requested that the interactions between default and migration risks be taken into account in the IRC modelling. As the diversification effect between these risks and other risks in the trading book are not yet sufficiently conceived, this effect should not yet play a role in the IRC modelling. This approach is justified by the Committee with the consistency with the Basel II Framework, which does not allow for the benefit of diversification when combining capital requirements for credit risk and market risk. In our opinion, the model banks should not be denied the option of taking diversification between the abovementioned risks into account within the model.

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Concentration

In the case of concentrations in the IRC model, the Committee explicitly insists on the consideration of concentrations in stress situations. We kindly ask you to illustrate how these stress situations can be taken into account in the model.

2. Validation

It is unclear how a validation of IR models can be provided for a one-year period at a confidence level of 99.9%. A validation using the usual market risk backtesting approach is not possible. In this respect we appreciate the corresponding clarification in the fourth bullet point. However, we doubt whether the stress tests mentioned in this point are suitable backtesting instruments.

In the first instance, it should be left to the discretion of the banks to conduct a reasonable validation. Only after market standards for modelling incremental risks have been developed can detailed regulatory requirements be imposed with regards to the validation. At the current point in time, the development of processes which would not contribute to the validation of the model should not be requested.

3. Frequency of validation

The Basel Committee envisages a weekly calculation of the incremental risk charge.
The parameters implied in the model, in particular the assumed minimum holding period of up to one year, are a disproportionately long period of time for trading products. In contrast, the calculation cycle of the IRC is very short. A one-week cycle is, in our opinion, too short a time to integrate the existing process cycles smoothly. Firstly, the technical calculation operations can often take more than a night. And secondly, the data for the weekly calculation and the results determined on this basis must be quality-assured and integrated into the internal risk management process. In order to be able to present such a process on a weekly basis, personnel resources would need to be increased and the technical systems would need to be developed further. This would require additional funds, which would once again reduce the incentives to carry out internal modelling. We therefore suggest that a chronological synchronisation is developed between the IRC calculation and the other reporting cycles and would support reporting on a monthly basis.

If the regulators are unable to implement this, they should at least provide the option of omitting weekly adjustment of insignificant calculation parameters and extremely time-consuming and expensive parameters. A purely quantitative determination of the regulatory volumes would be guaranteed despite this.

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4. Alternative Approach

We completely reject the alternative approach, according to which the capital requirements for all positions in the trading book that are subject to the specific risk capital requirements (or only for illiquid positions in the trading book) would be determined according to the regulations of the banking book. The application of the banking book regulations to such positions would be a significant step backwards for the risk measurement applied to specific interest and equity risks, which has been used for a long time and is well-established. Furthermore, such an approach must be considered to be problematic due to the lack of risk sensitivity of the measurement process, as market price risks, such as spread movements, are not reasonably depicted and concentration risks are also not adequately taken into consideration.

Should you have any questions, please do not hesitate to contact us.

Kind regards,

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