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EBF response to the consultative document by the Basel Committee on Banking Supervision:

Simplified alternative to the standardised approach to market risk capital requirements

EBF position

1. General remarks

The European Banking Federation welcomes the opportunity to comment on the consultative paper for a simplified alternative to the FRTB standardised approach. The proposed reduced sensitivities-based method (R-SbM) is a simplified version of the sensitivities-based method (SbM) and may only be applied by smaller banks with limited international activities that meet certain qualitative and quantitative criteria. In principle, we support more harmonisation in prudential standards that ensures greater comparability and level playing field between jurisdictions.

Generally speaking, we appreciate the ambition of having methodological consistency between the SbM, IMA and a simplified approach for less advanced banks. In its currently drafted form however, we believe that the design of the proposed R-SbM has some shortcomings. On the one hand, it does not offer significant simplification as it is still based on complex sensitivity-based calculations. On the other hand, it is not sufficiently risk sensitive in important areas (e.g. it requires only two delta sensitivities for GIRR, see 4a, and offers no preferred CSR risk weight treatment of covered bonds secured by real estate mortgages as compared to other exposures to "financials"). One particular proposed simplification of the R-SbM is the removal of capital requirements for vega and curvature risks. However, this simplification is of no importance if the R-SbM can only be used by banks with limited or no positions in options. Furthermore, the calculation methods for

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default risk charges (DRC) and residual risk add-ons (RRAO) are maintained and therefore do not bring any simplification.

Moreover, we consider that the criteria for using the simplified approach are too restrictive and may prevent banks with simple business models from applying this method. This would implicitly have an impact on bank's business models and force them to apply the more complex SbM.

In its consultative document the Committee also seeks views on whether the proposed reduced sensitivities-based method (R-SbM) or the Basel II market risk standardised approach with a so called "high-level recalibration" would serve as better alternative to achieve the goal of harmonising prudential rules across all jurisdictions. While the consultative document acknowledges that the proposed reduced sensitivities-based method (R-SbM) is significantly different to the design of the current Basel II standardised approach, it also acknowledges that the implementation challenges and costs may be dis-proportionate to the relative materiality of the trading book risks of the banks.

Although we are interested in the concept of the recalibrated Basel II market risk standardised approach as an alternative, it is difficult to make a judgement in the absence of further detail on the proposed "high-level recalibration" of the Basel II methodology. In this respect, we urge the Basel Committee to make explanations on the recalibration of a scaling factor transparent. If the Committee decided to implement further revisions that go beyond the scaling factor we would urge for an impact study and a consultation.

Conclusion: We appreciate the ambition of having methodological consistency between the SbM, IMA and a simplified approach for less advanced banks. But we are concerned that in its currently drafted form the proposed R-SbM does not offer appropriate simplification to make it a valuable alternative to the currently widely used Basel II methodology. We also share the Committee's concern of high implementation costs due to IT changes. As a result, we think that maintaining the Basel II methodology would be a better solution. This is particularly important for smaller banks, which would be disproportionately affected by the implementation costs.

The EBF seeks clarity on the following issues:

1. **Relation to the current FRTB standard:** It is our understanding that the Basel Committee's framework will be based on three approaches: IMA, SbM and a simplified standardised approach (R-SbM or recalibrated Basel II). We also understand that there is only one simplified approach and not two simplified approaches. We seek clarification whether this view is correct.

2. Timelines:

- A dis-alignment of timelines of transposition of the final Basel FRTB standard into national legislation and the proposed simplified approach coming into force should be avoided. Otherwise, institutions would be forced to implement the SbM (as in transposition of the final Basel standard) first although they may be eligible to apply the simplified approach at a later stage. This would create unnecessary implementation costs. Alternatively, an "opt-in option" could be envisaged for those banks eligible to apply the simplified approach and allow them the continued use of the current Basel II approach as long as the simplified approach is not applicable.
- Further, we have seen a number of jurisdictions including the United States of America, but also Singapore, Hong Kong and Australia that are delaying the implementation of the new market risk requirements and the European Union has proposed a phased-in approach. It is important that an uneven playing field in the regulatory framework across jurisdictions is avoided. In addition, there are some major pieces of the FRTB standard that are yet to be developed, and some have been re-opened at Basel level. The R-SbM proposal will be consulted on until 27 September 2017; thereafter the BCBS will need to consider responses before finalising the standard and realising impact studies to assess the calibration. Only at this point an incorporation into national legislation could realistically be considered.

2. Governance (para 204-208)

a) Para 204: To prevent instability in the way own funds requirements are calculated and to allow for sufficient time to adapt requirements in the assessment process we suggest that:
   i. The criteria assessment is not made more frequently than once a year.
   ii. The invalidation of the simplified approach is only asserted if the criteria are breached several times (for instance two consecutive quarters).
   iii. Sufficient time is given for the legal entity to develop the IT systems and infrastructures for the calculations under the standardised approach (SbM): for instance 6 months.

b) Para 204, 1st bullet point: Even if the simplified approach should not apply to large and internationally active banks, it should be considered that in some cases internationally active banks may also have a number of subsidiaries with small trading books. We urge that the simplified approach may be eligible at entity level for credit institutions with small trading books whether they belong to a large internationally active banking group or not. Clarification would also be worth on the approach applicable, at consolidated level, to risks pertaining to subsidiaries using the simplified approach, if the group includes non-eligible banks. It should be clarified that, if consolidated RWAs are determined through a "building block" approach (i.e. assembling RWAs at entity level), RWAs calculated with the simplified approach may be considered both at the entity level and at the consolidated level - provided that the subsidiary applies a simplified approach at individual level – even though the parent company or other banks apply different and more sophisticated approaches.

c) Para 204, 2nd bullet point: We do not understand the rationale behind the criteria that banks must not be engaged in writing options. It counteracts the basic simplification approach of waiving vega and curvature risks. These are only relevant when a bank uses options; hence the proposed simplification would not be applicable in practice. The application criteria would furthermore directly impact banks' business models because smaller institutes often apply commonly-used option strategies (e.g short butterfly) to efficiently manage risk. It is not clear to us if the proposed definition also includes banking book positions. We therefore propose to delete the strict prohibition of writing options or alternatively include exemptions and thresholds and suggest the following wording „*The sum of all delta equivalents of the options written by the bank must not exceed €5m (with the exception of back-to-back options and covered options whereby the bank owns the securities it may need to deliver under the terms of the option (micro-hedge) or as a strategic macro-hedge position for the banking book).*"

d) Para 204, 4th bullet point: We consider the €1bn threshold (of the bank's total non-derivative trading book assets and liabilities plus gross fair value of trading book derivative assets and liabilities) as too restrictive and recommend and increase to €5bn.

e) Para 204, 5th bullet point: Banks must meet certain criteria to use a simplified approach. One criterion is that the bank's total market risk-weighted assets divided by its total risk-weighted assets are less than 5%. We believe that this relative threshold is too low because it can easily apply to small institutes with long-term, non-trading related FX or commodity positions. We therefore propose to increase the threshold to at least 10%.

f) Para 204, 6th bullet point: We do not understand the rationale behind the proposal to make the aggregate notional amount of non-centrally cleared derivatives (incl. banking and trading book positions) one of the application criteria for banks to use a simplified approach. We propose the deletion of the proposition. The assumption that, in principle, smaller banks mainly use centrally cleared derivatives is questionable – as a matter of fact, in the EU EMIR regulation postpones to 2019 the central clearing obligation for financial counterparties with a limited volume of activity (i.e. those classified in "Category 3").

g) The consultation paper (para 205) asks for a prior supervisory approval for banks willing to adopt the simplified methodology, even though they fulfil all prescribed conditions. This would represent an undue compliance cost for both banks and supervisors. The EBF recommends that precise and objective eligibility requirements will be set and that banks meeting these requirements are allowed to apply the simplified approach without the need for prior approval by the supervisor. It seems reasonable that the supervisor retains the power to request a bank to apply the SbM in exceptional cases, e.g. when it ascertains that the simplified approach significantly underestimates the overall risk. Supervisory convergence should be fostered in that respect.

If the R-SbM were to be implemented we would make the following change requests:

3. R-SbM: structure (para 209-210)

a) The calculation of capital requirements for delta risks only differs from the new standardised approach (SbM) for market risks (BCBS 352) in one calculation step (para 210 (d)). This is not a simplification.

b) From a methodological point of view, the "default risk charge" and the "residual risk add-on" remain the same as the ones used for the standardised approach (SbM), whereas the "risk charge" is revised under the R-SbM. This is not a simplification.

c) The absence of correlation scenarios (high, low and medium) applicable to the R-SbM leads to an unbalanced situation vs. banks using the SbM.

d) The calibration of risk weights, x2-x3 (x3-x4.5 for liquid currencies) for GIRR, x2-x4 for CSR, x1.5 for FX is conservative. The calibration of the risk weights shall be reconsidered as they appear high in the context of small and usually fairly directional portfolios. One improvement would be to allow reduced risk weights for GIRR to selected liquid currencies as is the case in the SbM [BCBS 352 paragraph 75 §(a)].

e) Lower (GIRR) or similar correlations (CSR, FX): Note however that grouping the full-SbM buckets for CSR means that there are higher correlations recognised since the intra-bucket correlation is higher (35%). An impact study should be organised to assess the impact of these differences between the SbM and the R-SbM.

f) The SbM requires CIU (Collective Investment Undertaking) to be looked through. This is a very heavy exercise with little benefit considering the size of the portfolios eligible to the R-SbM. We therefore suggest that look-through is one possible option for CIU within the R-SbM and that CIU may also be treated as a single financial instrument.

4. R-SbM: Definition of the risk factors (para 211-218)

The requirements for the calculation of the GIRR and CSR sensitivities may be still too complex to implement and maintain for some small institutions or large banks' subsidiaries, which are not much exposed to market risks as they are mostly conducting treasury and liquidity management activities. We think that further simplifications are required:

Most precisely, we suggest that it is allowed, but not obligatory, to neglect marginal sensitivities (e.g. GIRR for CDS) and to approximate the sensitivity exposure by the notional amount adjusted with maturity for vanilla bonds.

For instance:

- Having T the production maturity in years, N the signed notional (positive =purchase, negative = sale):

- Vanilla fixed bonds (no step up): delta GIRR = - N * T / 10000 on the bucket 1st bucket if T <=5 on the 2nd otherwise. Delta CSR = - N * T / 10000
- Vanilla floating bonds (no step up): delta GIRR = 0, Delta CSR = - N * T / 10000
- Vanilla CDS (purchase=buy protection): delta GIRR = 0, Delta CSR = + N * T / 10000

a) General interest rate risk (GIRR) requires two delta sensitivities (for the band < or = 5 years and for the band > 5 years). Whilst this is a reduction compared with BCBS 352, it does not offer actual simplification because banks usually calculate delta sensitivities for interest rate risks in a more granular way.

b) For general interest rate risk (GIRR) we understand that the proposal does not explicitly require delta risk positions for rate curves within one currency. Compared with BCBS 352 this is a welcome simplification.

c) The credit spread delta risk (CSR) requires one delta sensitivity per risk factor curve, which is another welcome simplification compared with BCBS 352.

d) Requirements for the inflation risk, cross-currency basis risks, delta risks of equity, commodity and FX positions equal provisions of BCBS 352 and do not bring any simplification.

e) The R-SbM does not explicitly consider delta risk from equity-repos rates. Whilst this is a simplification compared with BCBS 352 the document leaves the question open to which extend these risk factors do not have to be capitalised or whether they have to be considered as a residual add-on.

5. R-Sbm: prescribed buckets, risk weights and correlations

a) Compared with the SbM the proposed R-SbM parameters are more conservative:
   - Risk weights for delta GIRR from yield curves at 5% are significantly higher than in BCBS 352 (1.5% - 2.4% depending on the duration)
   - Risk weights for delta GIRR from inflation risks and cross-currency basis risks at 3% are higher than in BCBS 352 (2.25%)
   - The correlation parameter for bands within delta GIRR risk factors from yield curves at 20% is significantly lower than in BCBS 352. The other correlation parameters for delta GIRR risk factors are the same as in BCBS 352.

b) The segmentation for delta CSR risk factors of non-securitisations is significantly less granular than in BCBS 352, which should be in principle a simplification. However, they lead to increased risk weights. The correlation parameters are less granular due to less granularity of the segmentation which makes them not directly comparable. The same applies to delta CSR risks of securitisations.
   The segmentation for delta equity risk factors is significantly less granular than in BCBS 352, which should be a simplification.

c) The segmentation of delta risks from commodity risks equals the segmentation of BCBS 352, however risk weights per segment are higher. Correlation parameters are unchanged.

d) The consultation document proposes a significant increase for delta risks of FX: 32% for certain BCBS defined FX pairs and 45% for all other FX pairs, which compares to 21% and 30% in BCBS 352. The correlation of FX risks of different FX pairs remains at 60%. The increased risk weights should lead to higher capital requirements compared with BCBS 352. Given that there is no simplification of the calculation method, this increase in risk weights appears unjustified.

About EBF

The European Banking Federation is the voice of the European banking sector, uniting 32 national banking associations in Europe that together represent some 4,500 banks - large and small, wholesale and retail, local and international - employing about 2.1 million people. EBF members represent banks that make available loans to the European economy in excess of €20 trillion and that securely handle more than 300 million payment transactions per day. Launched in 1960, the EBF is committed to creating a single market for financial services in the European Union and to supporting policies that foster economic growth.

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