

EBF response to the Consultative Document the by Basel Committee on Banking Supervision on: “Revisions to the minimum capital requirements for market risk”

EBF position

We welcome the Consultative Document, which addresses several important issues of the FRTB framework.

Concerning the standardised approach we welcome the Committee’s proposal on triangulated pairs of liquid currencies and welcome changes to the low correlation scenarios. We also support the reduction in risk weights but we feel that CVA risks should be aligned accordingly and monitored. Moreover, we call for a revision of the risk weights for credit spread risk for covered bonds. In addition, we advocate for a level playing field for FX curvature charges irrespective of the reporting currency and, therefore, propose that banks should be allowed to calculate the FX curvature charge in an alternative way.

Concerning the Internal Models Approach (IMA) we welcome proposals on the PLA test but we have some concerns about the metric design. We support the new Traffic Light Approach, but we are concerned that it is not smooth enough and remains digital to some extent. The calibration of real thresholds is necessary to assess the impact of the PLA test metric. Once the Basel Committee will have defined threshold for the PLAT (Profit & Loss Attribution Test), an observation period should begin to evaluate the calibration of these thresholds. The observation period should be concluded by a report assessing the impacts and considering the appropriate calibration of these thresholds. In addition, we believe that the concept of NMRF (Non-modellable Risk Factors) remains unclear in important areas and we request further clarification. The NMRF framework should recognize more diversification effects (beyond the idiosyncratic equity risk).

As far as the boundary between trading book and banking book is concerned we fully acknowledge and support the Committee’s intention to prevent capital arbitrage on risk transfers between trading and banking book. However, we are concerned about some

European Banking Federation aisbl

Brussels / Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu
Frankfurt / Weißfrauenstraße 12-16, 60311 Frankfurt, Germany
EU Transparency Register / ID number: 4722660838-23



www.ebf.eu

internal risk transfer (IRT) restrictions, especially when they relate to the treasury activities of a bank.

Finally, we consider it important that the simplified standardised approach for market risk is calibrated carefully compared to the new standardised approach to ensure that there are appropriate incentives for banks to invest in developing a more risk sensitive approach. But at the same time the calibration should not unduly penalise smaller banks, for which developing a more sophisticated approach is not proportionate to the size of their trading activities.

Detailed comments

1. Standardised approach

1.1 Revisions to the treatment of liquid FX pairs

We welcome the Basel Committee's proposal combining two currency pairs in the current list of liquid pairs, to create a new, triangulated pair of liquid currencies.

1.2 Revisions to correlation scenarios

We welcome the change to the low correlation scenario, which better captures the behaviour of basis risks in a stressed scenario.

1.3 Revisions to capital requirements for non-linear instruments

The approach to apply shock scenarios

While the Committee is working on an alternative proposal to apply scenarios consistently across different buckets, it is important to stress that the current formulation of the credit curvature could still lead to negative probabilities when downward shifts are applied to the credit spread curves. Such scenarios cannot materialize in the market so should be prevented by allowing to floor negative hazard rates (or spreads) to zero.

Potential double-counting of FX curvature risk

The industry welcomes the acknowledgement of double-counting in the FX curvature and the optionality introduced in Box 1, but is concerned about possible issues and unintended consequences of the treatment of FX pairs (i.e. the mixed granularity in aggregation may create broken hedges and artificially increase the curvature charge). Impact studies should inform the Basel Committee - and the industry - about the expected effects of FX curvature charge. The EBF also asks for a level playing field irrespective of the bank-specific reporting currency.

While the proposal in Box 1 may reduce the effect of double counting, however a one-size fits all approach for the definition of the scalar [X] would not be appropriate since the double counting effect is not constant over the currency pairs. To fully assess the impact we propose it to be tested as part of several consecutive Basel III monitoring QIS.

The Basel consultative document (d436¹) recognizes the specific double-counting issue, but it does not address dependency of the bank's reporting currency on the FX capital charges, including delta.

Capital charges remain dependent on the representation of the risk exposures. It turns out that twin portfolios could result with significantly different capital requirements solely depending on the bank's reporting currency. This is a separate issue from the double-counting in FX curvature and therefore needs to be addressed separately.

1.4 Revisions to risk weights

We support the reduction in risk weights applying to the standardised approach for market risk (general interest rate risk, equity and FX risk classes). However, it is important that the CVA risk will be aligned accordingly. This could be done by a transversal monitoring exercise in order to inform the industry and regulators of the capital requirement impact of these measures (FRTB and CVA) before any transposition of the Basel standard.

We are surprised that the review and recalibration of the risk weights of the new standardised approach does not include a revision of the risk weights for credit spread risk for covered bonds.

The table below compares the historical largest credit spread moves for investment grade issuances in the different sector buckets for non-securitisation with the assigned credit spread risk weights in the standardised approach. This shows that the assigned risk weights for credit spread risk in the standardised approach reflect the actual maximum historical credit spread moves over a 40-day holding period over 10 years quite accurately. This is in sharp contrast to covered bonds, where the credit spread risk is around 4 times the maximum historical 40-day credit spread moves.

Comparing the standardised approach credit spread risk weights to (historical) worst 40-day credit spread moves observed on various sector indexes/issuances.

Sector Bucket	Index	Largest historical 40 day credit spread move	SBA CS risk weight	SBA CS risk weight vs largest historical CS move
Financials, Investment Grade	JP Morgan US Financials (Spread to Libor)	490bp Since Jan. 2006	500bp	1.0x
Non-financials, Investment Grade	JP Morgan US Non-Financials (Spread to Libor)	293bp Since Jan. 2006	150-300bp Average: 238bp	0.8x

¹ <https://www.bis.org/bcbis/publ/d436.pdf>

Covered Bonds Investment Grade	Nykredit DK(1) DK	83bp Since 2002	400bp	4.8x
	Realkredit Danmark (1) DK	114bp Since 2002	400bp	3.5x
	Nordea (1) DK	100bp Since 2002	400bp	4.0x
	SEB(2) SE	85bp Since 2002	400bp	4.7x
	DNB Boligkreditt 5Y (Spread to NIBOR)	31bp Since 2007	400bp	12.9x

1-Spread between the 10Y-point on the Nykredit, Realkredit and Nordea mortgage curve and the 10Y-point on the DKK benchmark swap curve.

2- Spread between the 5Y-point on the SEB mortgage curve and the 5Ypoint on the SEK benchmark swap curve.

Source: Danske Bank, Bloomberg

This illustrates that the 400bp risk weight for credit spread risk applied to high quality covered bonds under the standardised approach requires a substantial adjustment to be more reflective of their true risk and to resolve inconsistencies in the treatment of the different asset classes within the framework.

Given the evidence provided as to the structural features of the covered bond markets and historical data, and also in order to address the inconsistencies in the treatment of different asset classes across the standardised approach, a credit spread risk weight of 100 bp for investment grade covered bonds seems reasonable.

1.5 Other clarifications

1.5.1 Treatment of multi-underlying options and index instruments

A look-through approach must be used for index instruments and multi-underlying options in the delta risk context. If the no look-through approach is adopted, the risk weight to be applied to the index/multi-underlying option for the computation of the curvature risk charge should be the highest prescribed delta risk weight for each of the delta risk factors in the curvature risk requirement. The highest RW could pertain to components of the basket/index that are not representative of the overall composition. In this case, a RW selected from the most representative components (or an average RW) could better reflect the effective riskiness.

1.5.2 Default risk charge (DRC) for securitisations

The Basel standard for market risk (d325²) describes in paragraph 161 the SA-DRC methodology for securitisations (non CTP) as similar to the methodology given for non-securitisation credits but with specific risk weights that are given in the Basel standard on the Revision of the securitization framework (d374³).

Among other precisions it requests that the hierarchy of approaches given in this last BCBS to be respected.

The problem is that only the SEC-ERBA approach is actually similar to the market risk approach, that is to say based on risk weights that depend on ratings and that are applied to notional exposures. Moreover, the other approaches require data that are not systematically available on the trading perimeter. For all these reasons we would like to have the possibility to use the SEC-ERBA approach for the trading book in the context of the FRTB SA-DRC.

2 Internal models approach

2.1 P&L attribution test (PLAT)

2.1.1 PLA test input data

We welcome the introduction of differences between the two measures of P&L (HPL and RTPL), such as the difference in the times at which market data are collected and the difference of data providers to source the inputs for the calculation.

2.1.2 PLA test metric design

We support the PLA test proposal, in particular the introduction of a Traffic Light Approach, the quarterly frequency at which the test is to be conducted, the extension of the time series length and the design of the test metrics themselves. Moreover, we ask for a calibration of PLA test thresholds on real data.

However, it is crucial to stress that, despite the improvements, the metrics and in particular the Spearman Correlation test are still plagued by the “noise” issue. Namely, when a desk is well hedged, the test mainly measures the correlation between two noises resulting from possible hedges mismatches that, by its very definition, is close to 0.

Here an example of the hedging effect. We split a real portfolio into subcategories, Cross Currency Swap (CCS) and the rest (no CCS), which hedge each other as showed in the following plot.

² <https://www.bis.org/bcbs/publ/d352.pdf>

³ <https://www.bis.org/bcbs/publ/d374.pdf>

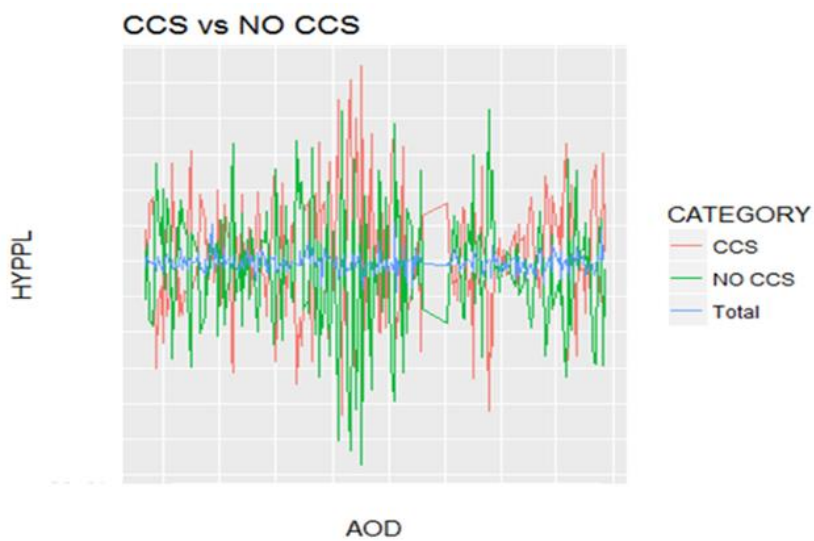


Figure 1: Hypothetical PL of the hedged portfolio together with its components.

The table below reports the results of the test applied to CCS, no CCS and the entire portfolio given by the sum of the two.

Perimeter	Spearman Cor	KS	TL
CCS	0.94	0.04	Green
NO CCS	0.93	0.05	Green
Total	0.57	0.13	Red

Although the two subcategories pass the test, the resulting hedged portfolio does not. The following plots provide a graphical evidence of the decorrelation effects due to hedging.

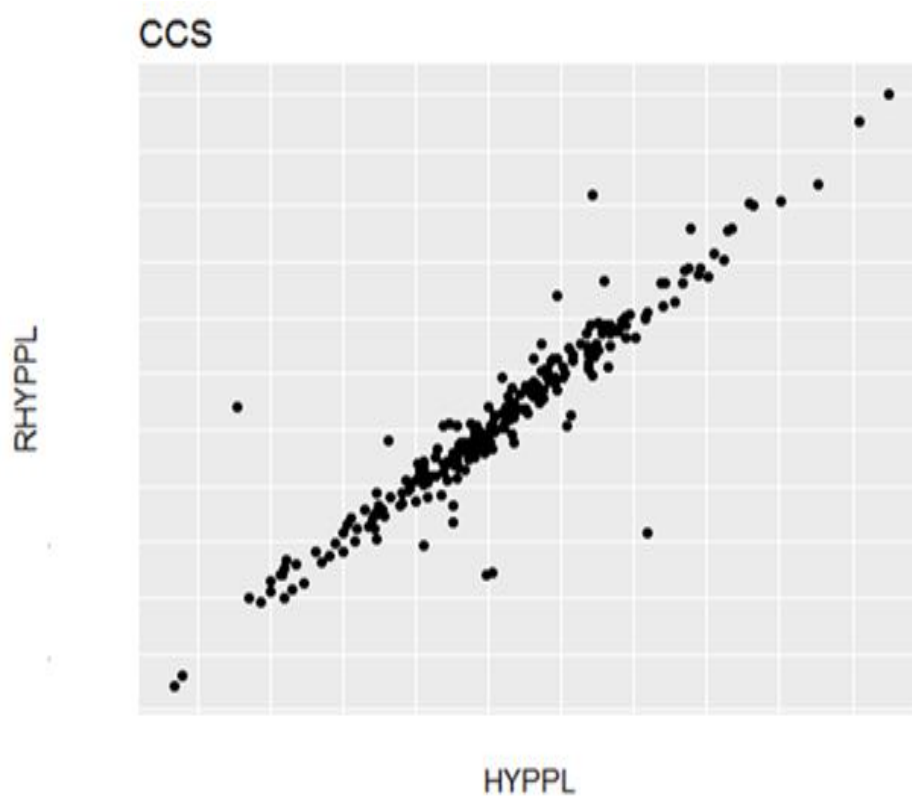


Figure 1: RTPL vs HYPL for CCS

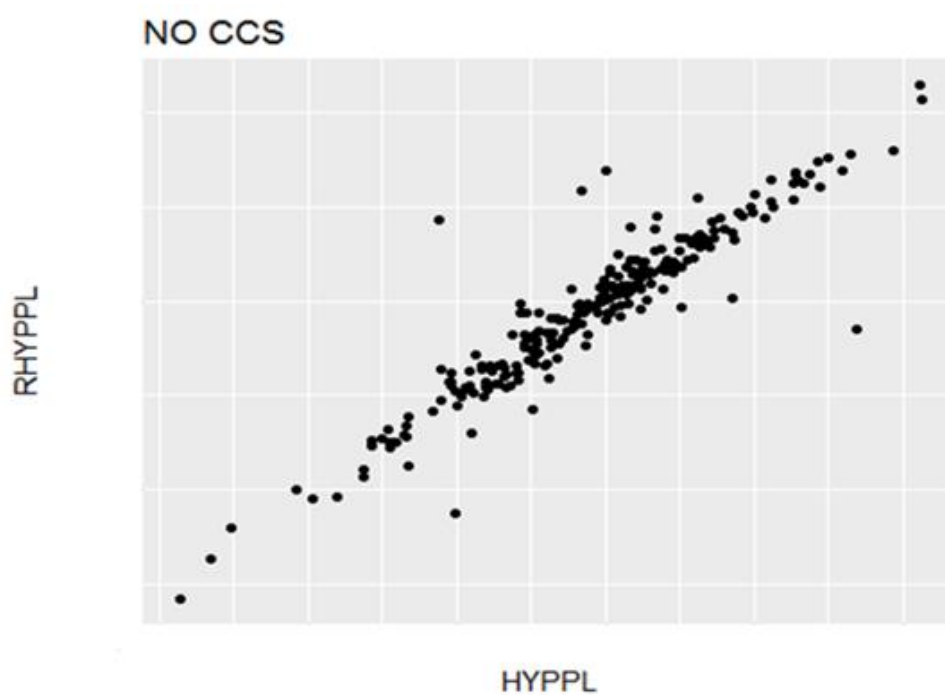


Figure 2: RTPL vs HYPL for no CCS.

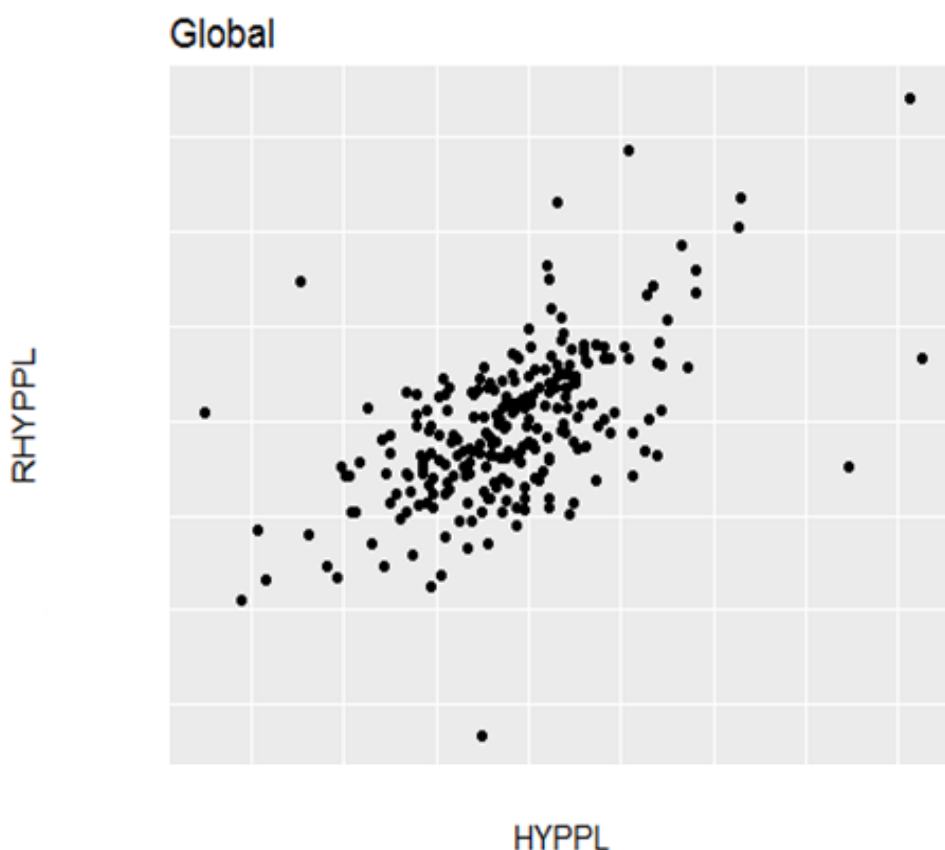


Figure 3: RTPL vs HYPL for the hedged portfolio.

For this reason, it is important to discriminate between low volatility (hedged) and directional portfolios. Subject to supervisory approval banks should retain the possibility to remove any PLA failure if a dedicated analysis shows that it is due to the hedged nature of the desk. An example of analysis could be:

1. split the desk into two (or more) partitions, for instance one could contain the positions and the other one the corresponding hedges (i.e. create two directional sub-desks)
2. perform PLA test on the two sub-desks, then
 - a. if both are GREEN, the failure is disregarded as due to noise, otherwise
 - b. the failure is registered

Regarding the alternative between the “Kolmogorov-Smirnov (KS) test metric” and the “Chi-squared test metric”:

The measurement of “similarity” between hypothetical (HPL) and risk-theoretical P&L (RTPL) distributions is intended to assess whether the risk management model used for the trading desk sufficiently captures the P&Ls of the desk across the range of market conditions during the previous 12 months. Two alternative tests are proposed: the Kolmogorov-Smirnov (KS) test metric and the Chi-squared test metric.

Both tests are fairly standard and preliminary analyses suggest that KS and Chi-squared metrics behave similarly. The Basel Committee should define a revue clause in the final Basel framework for market risk. This revue clause should permit to revise the alternative

between the “Kolmogorov-Smirnov (KS) test metric” and the “Chi-squared test metric” leaning on real data.

2.1.3 PLA test failure consequences

As mentioned, we support the Traffic Light Approach, which applies to trading desks that failed the PLA test. Nevertheless, we would like to point out to the Committee that the new approach is not smooth and remains digital to some extent. Indeed, although we note that the Committee continues to monitor the calibration of the thresholds to ensure their appropriateness, we regret that a trading desk that failed in the “red zone” cannot return in the “amber zone” and has to meet all the requirements to comply with the “green zone”. This requirement is very demanding. We ask for a framework reflecting model improvements made by a firm sooner when metrics fall back to the “amber zone”. This improvement should be included through a progressive capital charge applying to portfolios failing in the PLA test (progressive capital add-on leading to a standardised fully diversified approach).

Moreover, it should be mentioned that the capital charge applying to a portfolio failed in the “amber zone” should not be higher than the capital charge under the standardised approach.

We ask for a symmetrical Traffic Light Approach that permits trading desks to switch from the “red” to the “amber” to the “green”, similar to how desks in the “green zone” switch from “green” to “amber” to “red”.

Furthermore, the consultative document d436 does not explain the impacts of this framework on the day 1 approval process.

2.1.4 Trading desk requirements

We welcome the softening inception allowing a bank to assign an individual trader to work across two trading desks, subject to supervisory approval.

Description of the PLA and Back-testing frameworks at the trading desk level (Annex B §B.4 II)

NMRF in the context of Back-testing

In the text of the Consultative Document (CD), the RTPL used for PLA and back-testing (BT) should be based on the “desk risk management model”.

According to the Glossary:

“The desk risk management model includes all risk factors that are included in the bank’s ES model with supervisory parameters and any risk factors deemed not modellable by the supervisor in Step 3, and which are therefore not included in the ES model for calculating the respective regulatory capital charge, but are included in NMRFs.”

Desk eligibility tests (PLA and BT) are conceived to produce an assessment of the Desk Risk Management Model. In order to retain an overall consistency of such assessment, VaR used for BT should be allowed to also incorporate NMRF.

Indeed, the 2016 Basel standards⁴ clearly indicates PLA and BT as step 2(ii) of the Market Risk flowchart, whose failure leads to the application of the SA. Only with the following Step (3) modellability is introduced to distinguish between two different types of IMA Capitalization.

In addition, Annex D, which defines the principles that must be applied to determine whether a risk factor that passed the risk factor eligibility test (i.e. PLA and BT), can be modelled using the expected shortfall model or should be subject to a non-modellable risk factor (NMRF) charge, implicitly confirms that VaR used for BT should not carve out NMRF.

A clear statement on the matter is however not present, possibly leading to different interpretations in local jurisdictions⁵.

P&L Definitions

The CD requires P&L effects due to the passage of time to be included in the actual P&L and to be treated consistently in both HPL and RTPL. Time effects can include various elements such as: the sensitivity to time, or theta effect (i.e. using mathematical terminology, the first-order derivative of the price relative to the time) and carry or costs of funding.

Such requirement is welcome in that it positively clarifies the treatment of the passage of time in the definition of actual P&L, removing the need to carve out non-better-specified net interest income effects as required in some jurisdictions⁶.

Additionally, it sets the requirement that both actual P&L and HPL must be computed based on the same pricing models (e.g. same pricing functions, pricing configurations, model parametrisation, market data and systems) as the ones used to produce the reported daily P&L.

The condition that the systems producing actual P&L and HPL need to be the same appears not necessary to guarantee the similarity of the pricing models and should hence be excluded by the list of exemplifying conditions.

2.2 Non-modellable risk factors (NMRF)

2.2.1 Process for satisfying modellability requirements and expectations for internal model calibration

First, it is important to underline that the concept of NMRF remains unclear in important areas and we request further clarification. We would appreciate clarity on the exact purpose of the NMRF test taking into account the following observations:

- Poor observability of a risk factor does not necessarily lead to non-modellability, in particular when it comes to idiosyncratic risks.
- If a risk factor is non-modellable this would be unveiled through backtest and PLA test where the suitability of the risk models and the choice of risk factors are assessed. Moreover, multi-factor models, which are appropriately calibrated using representative historical data to capture both systemic and idiosyncratic risks, should be recognised, leading to both types of risk classified as modellable.

⁴ BCBS Minimum capital requirements for market risk, January 2016

⁵ As the draft Article 325bg of the revised EU Capital Requirements Regulation (CRR2) clearly shows.

⁶ In the EU such treatment is currently set out in Article 366 CRR.

- The liquidity horizons are designed to capture poor liquidity, so why not solve the issue by simply bumping the liquidity horizons within the internal model with bumps that are reflecting the liquidity/observability of the risk factor?

Moreover, the whole NMRF framework is operationally complex and goes prudentially far from a commensurate and sensitive risk assessment.

The CD proposes two potential alternatives to determine how similar a risk factor of an executed transaction and a risk factor used to evaluate a financial instrument must be in order to count as an observation for the risk factor eligibility test (RFET).

Alternative 1: it requires that exactly one risk factor per bucket must be defined, and the risk factors must correspond to the risk factors that are part of the RTPL of the bank for the purpose of the PLA test. An explicit trade-off between expected shortfall (ES) granularity and PLA granularity is established since the use of more granular buckets may facilitate a trading desk's success in meeting the requirements of the PLA test, but additional granularity may challenge a bank's ability to source a sufficient number of "real" observed prices per bucket to satisfy the RFET.

Alternative 2: it proposes instead a standard bucketization of the risk-factors that does not explicitly imply a trade-off with the PLA granularity. Despite the fact that Alternative 2 is still posing an extremely demanding buckets granularity across the strike dimension, the diriment point when preferring one alternative to the other is the actual requirement to have the same granularity between PLA and RFET. In case such requirement is indeed not present in Alternative 2, then a standardized bucketization that is less-granular in the strike dimension would be the preferable option.

We would support a more flexible version of alternative 2 (e.g. for strike and maturity dimensions of volatility surfaces, to avoid excessive granularity creating artificial non-modellability). Alternative 2 contains many more parameters than needed by a credit institution. That being said, alternative 2 needs the following useful clarifications:

- For interest rate options, it should be specified that the bucketing of the underlying swap maturity is 6 as given in the SBM vega GIRR.
- Parametric models may be used to describe the strike dependency in the volatility structure (e.g. SABR model) and the mapping to the 8 proposed buckets for strike dimension is not relevant. In this case, each model parameter should be considered as a single risk factor, and modellability evidenced via the 6 or 6x6 underlying buckets described above as soon as the parameter is time-dependent.

As regards "Annex D" of the consultative document:

- Preamble: It should be made very clear that the principles apply only to risk factors that are already included in the ES model. RNIM do not need to be capitalised if the model without them passes PLA and BT. See in particular for Principle 2 below, regarding idiosyncratic risk.
- Principle 1: While allowing the use of combinations of modellable risk factors, it establishes a link between ES configuration and PLA. How such prescription relates with Alternative 2 for modellability assessment needs to be clarified.
- Principle 2: The principle should consider a materiality threshold of the idiosyncratic risk. As a consequence, the last phrase of principle 2 should be modified as follows:

***“If the data used in the model do not reflect either idiosyncratic or general market risk and if the P&L attribution test confirmed the materiality of the idiosyncratic or the general market risk, the bank must apply an NMRF charge for those aspects that are not adequately captured in its model, if the institution chooses to reflect those aspects in the ES model, assessed using P&L attribution and back-testing.*”**

- Principle 3: The principle seems overly prescriptive. The framework identifies PLA attribution and Back-testing as the means to assess the quality of the Desk Risk Management model, which admits the use of proxies. A model that passes those tests would have provided enough evidence of its adequacy in capturing volatility and correlations among the relevant risk factors. There hence seems to be no need to impose additional qualitative requirements on top of the already prescribed quantitative ones. We propose to remove Principle 3.
- Principle 4: The principle seems overly prescriptive. NMRF definition already prescribes clear rules to establish a link between risk factors and real price observations. Additional comparison between front office vs back office vs risk prices would suffer for the incorporation of noise elements like time snapshots, bid/ask, CSA impacts and would pose a significant operational burden. We propose to remove Principle 4.
- Principle 5: “Sufficient frequency” of model recalibration should be mindful of risk type that is captured in a model. E.g., rare events, like currency de-pegging or rating transitions, should not be subject to the same calibration frequency as market quotes that are changing daily.
- Principle 6: We urge the Basel Committee to define a flexible framework to define the data used to determine stressed expected shortfall (ES) reflective of market prices observed or quoted in the period of stress. Indeed, to some extent, and after the approval of the supervisory authority, proxies should be authorised for the stressed ES model during the stress period. Proxies should be authorised for non-reduced sets, as long as this treatment is authorised by the competent supervisory authority.

Modellability is assessed on the current window under well identified criteria to establish a connection with real price observations. Coverage of the stressed period occurs via a reduced set of risk factors, which might incorporate proxies that are available across the whole history. The principle seems to pose additional constraints on the characteristics of the reduced set of risk factors that seem new in the context of the discussion of the criteria needed to be eligible for inclusion in the ES measure. We would suggest to either better specify the additional set of requirements for a risk factor to be admissible for the reduced set or to remove Principle 6.

- Principle 7: It remains conceptually unclear how “combinations of modellable risk factors are to be considered as proxies”. Moreover, this requirement seems inconsistent with the requirements defined in the Basel standard issued in January 2016 (BCBS d352). Combinations of modellable risk factors are to be considered as modellable (paragraph 183c). It should be made clear and unambiguous that the requirement of extra capitalisation⁷ is relevant to existing data proxies only and is not in contradiction to the general principle of the original text⁸, stating that choice of

⁷ «If risk factors are represented by proxy data in the ES model, the proxy data representation of the risk factor – not the risk factor itself – must be used in the RTPL unless the bank has identified the basis between the proxy and the actual risk factor and properly capitalised the basis as an NMRF.» (BCBS d436, p. 32-33)

⁸ Basel d352, Appendix B.II.4, “P&L Attribution”

modelling a single-name (e.g., via multi-factor framework) does not affect the ability to use its actual return in PLA, with no extra conditions.

2.2.2 Impact of the NMRF framework on seasonal markets

The current max gap rule (i.e., a quote at least every 30 days) is biased unfavourably against local markets with periods of traditional long holidays, such as China ("Golden Weeks"), Middle East and Gulf countries ("Eid"), Russia (New Year and Orthodox Christmas), etc. Furthermore, prolonged holiday periods in August, as well Christmas and Easter periods may tip over the relatively less liquid European markets into NMRF terrain, despite having ample trading activity throughout the year. The current stringent modellability rules are thus likely to bring heavy capital impact, via punitive SES charges, on the following markets:

- Russia, China and Gulf states (rates and volatility);
- Long-term European treasuries, as well as long-term repos for sovereigns.

The consequences of punitive capital charges will be reduced activity in these markets, which will only aggravate any nascent liquidity issues and reduce, not foster, market depth and diversity. Alternatives to the 30-day max gap rule should thus be considered, in order to give the markets time to react and create more liquidity following a quiet period. "3-in-90" or "weighted average" gap rules are examples of such alternatives.

2.2.3 Impact of NMRF idiosyncratic equity risk

We welcome the Committee's proposal to revise exceedingly high capital requirements for equity risk NMRFs.

- Regarding the risk factors in the scope of the adjustment (spot, forward, volatilities, dividends, repos) we expect that a significant number of them will be non-modellable (except for spot).
- We also expect that after elimination of the general market risk (through the application of footnote 40) they will be mostly uncorrelated.

It could remain a statistically significant correlation for a small set of risk factor pairs, with a very small impact on the risk of the portfolio. We recommend that the statistical "pair by pair" approach currently given in example in the text (and which represents a significant burden) is replaced by the verification at portfolio level that the square-root-sum-of-squares aggregation leads to an adequate capital charge.

- Consequently, the proposed aggregation scheme is expected to reduce significantly the SES charge on the equity risk class.
- Some non-idiosyncratic equity risk will remain (notably those linked to exotic risk factors), and the impact on the full SES charge will also depend on the portfolio of the bank and its business profiles across other risk classes.

Moreover, we would like to stress the Basel Committee that this issue is not only a model design issue but also a political concern impacting some geographical zones. Indeed, if the banks cannot benefit of this more suitable and economically sound amendment, this will prevent small and mid-sized corporates from access to capital markets.

Most of the risks to be capitalized under NMRF are going to be idiosyncratic risks. As such, the proposal to have equity along with credit aggregated under a zero correlation

assumption is welcome. Similarly, the residual aggregation rule for non-equity/credit risk factors appears extremely conservative assuming full correlation among NMRF. A milder correlation assumption should be allowed, potentially after some assessment period on the impacts of a 100% correlation on real portfolios. The introduction of a correlation parameter that can be fine-tuned in the future would indeed offer a lever to set NMRF to a desirable level of capitalisation.

2.2.4 IMA – Default Risk Charge (DRC) – not part of the Consultative Document

Despite not being covered by the Consultative Document, there are two points on the Default Risk Charge (DRC) that are deemed particularly relevant.

Sovereign Floor

The proposed floor for the probability of default (PD) in the IMA default risk charge is set at 3 basis points across all issuer types. The floor is not risk-sensitive which puts disproportionately high capital requirements on bonds issued by high credit quality issuers, e.g. AAA rated government and covered bonds, which could impact liquidity negatively. The liquidity of these assets needs to be considered in the context of a 1 year PD horizon. In practice, given that these are typically high quality liquid assets, a bank will have the ability to manage such portfolios if credit quality deteriorates. A 1bp floor would hence appear more adequate.

Rolling Futures Hedges

The 2016 Basel Text requires the model to capture any material mismatch between a position and its hedge. With respect to default risk within the one-year capital horizon, the model must account for the risk in the timing of defaults to capture the relative risk from the maturity mismatch of long and short positions of less than one year maturity.

While this could make sense for a static CDS/bond hedging strategy, it may lead to fake open risk for a dynamical rolling long bond/ short future hedging strategy. Indeed, the future is usually short term so that one ends up with a naked bond position for most of the time simulation.

Position \ Default Time	3M	6M	9M	1Y
Future (Maturity = 4M)	-JTD	0	0	0
Bond (Maturity = 10M)	JTD	JTD	JTD	0
Portfolio	0	JTD	JTD	0

In reality future is rolled upon expiry so the hedge is always in place. Even in the presence of a market disruption leading to a melt-down of the Futures market, at the Futures expiry the bond would be delivered so it would be no longer in the portfolio. We recommend that rolling hedging strategies be exempted from any maturity mismatch effect.

2.2.5 IMA – Aggregation of other NMRFs – not part of the Consultative Document

The simple sum aggregation of other NMRFs is overly penalizing, and is not related to any risk management / risk sensitiveness approach. This is particularly true given the high number of non-modellable risk factors (the simple sum aggregation corresponds to a scenario where each risk factor moves in the adverse way for the bank) and given the fact that each NMRF is allowed to be represented as a MRF proxy plus a NMRF basis, leading to non-perfectly correlated (relatively low correlated indeed) behaviours: the probability of the underlying scenario is more than extremely small.

This should also be viewed in a context where a lot of uncertainty remains on what be the exact scope of NMRFs⁹ with a risk that the SES charge may be multiple times the ES+DRC charge IMA, and moreover induces a great variability of IMA from time to time not reflective of actual risk.

Those concerns can be addressed with a simple aggregation mechanism, inspired from the “Basic Approach for CVA”, where the SES charge would be the sum of the idiosyncratic credit spread risk charge, the idiosyncratic equity risk charge, and an aggregation of the other NMRFs:

$$SES = \sqrt{\sum_{i=1}^I ISES_{NM,i}^2 + \sum_{j=1}^J ISES_{NM,j}^2} + \sqrt{(\rho * \sum SES \text{ s of all other NMRFs})^2 + (1 - \rho^2) * \sum (SES \text{ s of all other NMRFs})^2}$$

This mechanism is based on a single parameter ρ that can be interpreted as an average correlation across non-modellable risk factors. Quoting / adapting the regulatory text (d424): “In the formula above, the effect of ρ is to recognise the fact that the NMRF risk [CVA risk] to which a bank is exposed is less than the sum of the NMRFs risk for each risk factor [CVA risk for each counterparty], given that the NMRFs [credit spreads of counterparties] are typically not perfectly correlated.”

In addition to the economical soundness brought by this recognition of the lowering of the correlation after application of footnote 40, it is worth noting that the parameter ρ provides the regulator a lever flexible lever to regulate the impact of NMRFs.

The calibration of ρ may be done after a monitoring phase.

3 Scope of market risk capital requirements

3.1 Treatment of structural FX positions

The Basel proposal is welcomed. Nevertheless, we would like to underline the following concerns:

- The structural open FX position depends on a management choice. It is a long- term choice with the objective to reduce the sensitivity of the ratio to FX variations.
- All FX positions should be considered in the net and structural FX position, whether managed in the trading book or in the banking book and irrespective of the booking (in a branch, in a subsidiary, at operating level or at holding level), the accounting or the underlying instruments.

⁹ In particular, it is too early to assess the real benefits of data pooling; we can also expect seasonality effects...

- The maximum size of the structural position should be determined in reference to the actual or target capital ratios (CET1), in order to fulfil the objective of reducing the ratios to FX movements. Hedging the ratios sensitivity should be constructed as “reducing” the FX-sensitivity not as fully neutralising the FX sensitivity. Structural net assets (or net assets equivalent positions in derivatives) that are taken or maintained with a view to reduce this sensitivity must be considered as an acceptable strategy.

We ask for the following adjustments in the “Annex E.1 - Revisions to the treatment of structural FX positions”:

« 4. [...] :

(a) The risk position is taken or maintained for the purpose of hedging partially or totally against the potential that changes in exchange rates could have an adverse effect on its capital ratio.

(b) The risk position is of a “structural”, i.e. of a **durable** ~~non-dealing~~, nature such as positions stemming from:

- investments in affiliated ~~but not consolidated entities~~ denominated in foreign currencies **(participations in subsidiaries, branches, non-distributed P/L of these entities...)**; ~~or~~

- ~~investments in consolidated subsidiaries or branches denominated in foreign currencies.~~

- **hedges of investments in affiliated denominated in foreign currencies**

- **tangible & intangible assets**

- **capital operations**

(c) The exclusion is limited to the amount of the risk position that neutralises the sensitivity of the capital ratio **(current or target)** to movements in exchange rates.

~~(d) The exclusion from the calculation is made for at least six months.~~

(e) The establishment of a structural FX position and any changes in its position must be pre-approved by the national supervisor.

~~(f) Any exclusion of the risk position needs to be applied consistently, with the exclusionary treatment of the hedge remaining in place for the life of the assets or other items.~~

(g) The bank is subject to a requirement by the national supervisor to document and have available for supervisory review the positions and amounts to be excluded from market risk capital requirements. »

We ask for:

- The deletion of paragraph (d) because we believe that the reference to this six-month minimum period should be removed. For example, the P&L of the subsidiaries is hedged at year end. In April, most of them will distribute their dividends to their mother companies. Hence at this time, and not at end of June, the FX exclusions must be adjusted;
- Paragraph (e) should be completed with some examples;

- As regards paragraph (f), we do not understand the reason why the hedge should remain in place for the life of the assets. This paragraph remains unclear and we ask for its deletion.

3.2 Boundary between the trading book and the banking book

We are in general concerned about the hard restrictions on risk transfers between trading book (TB) and banking book (BB). We fully acknowledge and support the Committee's intention about preventing capital arbitrage through reallocation of securities and transfers of risk. However, in order for ALM functions in Treasury to manage the funding and liquidity of the whole bank, transactions such as repo's, currency swaps etc. across the TB-BB boundary are unavoidable. Such ALM transactions should therefore be exempt from internal risk transfer (IRT) restrictions. Regarding securities trading, it should be possible for BB to trade with the market maker desk in TB on the same terms as any other client, i.e. at arm's length and at market conditions.

Paragraph 16: We support the exclusion from the market risk framework of the following instruments:

- The part of syndicated loans to be distributed. Indeed, such loans are not traded on an active two-way market.

The proposed revisions also clarify under what conditions equity investments in funds (e.g. exchange-traded funds) can be included in the trading book. Under the proposals, banks may assign to the trading book funds: (i) for which daily price quotes are available; (ii) which track a non-leveraged benchmark; and (iii) which demonstrate a tracking difference, ignoring fees and commissions, for which the absolute value is less than 1%.

We understand the proposal as admitting a fund to the TB if either

1. daily real price (NAV) and look-through are available, or
2. daily real price (NAV) is available but look-through is not. However, the fund tracks a non-leveraged benchmark with a tracking difference below 1%.

The risk associated to a fund is well reflected by its daily NAV fluctuations and can be appropriately captured in a Trading Book framework. Banks should therefore be allowed to assign funds to the TB provided that daily NAV is available, even though daily look-through is not.

After that, a proper treatment under standardised approach (SA) and Internal Model Approach (IMA) should be specified. Our proposal is the following:

- **IMA**

- Expected Shortfall: use the times series of daily NAV and introduce dedicated liquidity horizons (or provide guidelines on how to map to the existing liquidity horizons)
- Default Risk Charge: in order to properly compute a jump-to-default, the fund composition would be needed. However, being a one-year horizon measure, having an "approximate" composition should not affect the accuracy of the results. By "approximate" composition we mean a composition assessed on a monthly (as opposed to daily) basis or inferred from the fund mandate

- **SA**

- Sensitivity Based Approach: introduce a bucket dedicated to “Funds” (or multiple buckets according to the mandate/fund type) with a properly calibrated risk weight or provide guidelines on how to map to the existing buckets. Only funds whose mandate is not known should be assigned to the “Other sector”.
- Default Risk Charge: as for IMA

As to the eligibility requirements, we would highlight that the proposed 1% threshold for the tracking difference seems a rather unfeasible condition. This would hamper the possibility of assigning to the TB funds genuinely hold for trading purposes and for which a proper capitalisation under the market risk framework would be possible (as described above). We would therefore suggest deleting such condition. In addition, the reference to the “non-leveraged” condition is unclear (leverage would in no way comprise the bank’s ability to look to the benchmark for risk capture).

4 Simplified alternative to the standardised approach

The simplified alternative to the standardised approach is a recalibrated version of the Basel II standardised approach, applying a multiplier to the capital requirements in each risk class of the old Basel II standardised approach. This approach should be carefully assessed by supervisory authorities before its implementation. This assessment should confirm the commensurateness of the proposed calibration. It is important that the simplified standardised approach for market risk is calibrated carefully compared to the new standardised approach to ensure that there are appropriate incentives for banks to invest in developing a more risk sensitive approach. But at the same time the calibration should not unduly penalise smaller banks, for which developing a more sophisticated approach is not proportionate to the size of their trading activities.

If we agree that the simplified approach should not apply to globally systemically important banks (G-SIBs), it should be considered in the transposition how much this recalibrated version of the Basel II standardised approach should apply to subsidiaries and branches of G-SIB with small trading books, as they meet the other criteria (no use of internal model for determining the market risk capital requirements for part of their trading book and no correlation trading portfolios) on a standalone basis for the calculation of market risk own funds requirements. If subsidiaries and branches are allowed to use this simplified methodology, it should be clarified that RWAs calculated with the simplified approach at the entity level may be considered at the consolidated level of a group.

Due to LCR regulation small and non-complex banks may hold considerable positions in LCR securities - over and above 5 or even 10 per cent of total assets - that are traded regularly and therefore liable to be categorised as trading book positions. It is important that these banks are allowed to use the simplified standardised approach.

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.

www.ebf.eu @EBFeu

For more information contact:

Sarah Schmidtke

EBF Frankfurt Office Representative

s.schmidtke@ebf.eu

+49 151 16819281