

Comments

on the Consultative Document “Fundamental review of the trading book: outstanding issues” (BCBS 305)

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent more than 2,000 banks.

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I. General comments

In the course of the work on the "Fundamental Review of the Trading Book", many improvements were made, also at the suggestion of the banks and associations, so that the current drafts of the requirements basically represent a passable way for all those involved.

Nevertheless, the formulation of a number of provisions without which we cannot finally assess the Basel Committee's work on the trading book review are still missing in the current third consultative paper and likewise in the full text of the trading book requirements. For example, the validation of the sensitivities on the basis of the bank-internal pricing models was fully excluded in the standardised approach in the third consultative paper. Likewise, for example, precise statements on the risk-independent so-called Risk Assessment Tool (RAT), which we continue to see as very critical, are still missing, or on the calibration of the now apparently "set" floor regulation of the internal models by the standardised approach. According to our information, there will be another two impact studies in 2015 (from February 2015 and in the third quarter of 2015). However, with respect to the changes to the standard model, there are some unclear points regarding calculation, where clarification and concrete calculation examples would be helpful primarily against the background of the planned QIS, like those represented in Box 2 of the consultative paper for the consideration of the basis risk. This would result in improved comparability of the QIS results. We believe it is absolutely necessary to incorporate the results of these studies in the text of the regulation.

Based on these considerations, another consultation should be performed prior to the publication of the final regulations. In this regard, we doubt whether the results of the quantitative impact study being conducted in 2015 can appropriately be processed by the end of 2015. In particular, we find the calibration of the individual elements of the fundamental review very demanding.

II. Specific comments

1. Risk transfer between banking book and trading book

The Basel Committee puts two options forward for discussion. In **option 1**, the bank must acquire a hedging instrument which precisely corresponds to the Internal Risk Transfer (IRT), so that neither the internal nor the external hedge is backed with regulatory capital in the trading book. Alternatively, the supervisory authority may demand that the internal and the external hedge be included in the calculation of the capital requirements regarding the market risk. In both cases, however, no market price risks remain in the trading book. We interpret the present proposal to mean that only the internal risk transfer and the external counter-transaction have to be an "exact match". The original transaction in the banking book and the internal risk transfer, on the other hand, do not have to be an exact counter-transaction. We request confirmation that this understanding is correct. Otherwise, the original transaction, the IRT and the external counter-transaction would have to match. However, this is normally not possible, or if it is, then only on very unfavourable terms because those based on banking book positions can, on the one hand, be very small (e.g. based on share bonds or callable bonds) and, on the other hand, cannot be reflected by standard trading books (e.g. short or "odd" terms).

Nevertheless, an essential argument from banking practice speaks against allowing the specifications of option 1 as the only possible solution – portfolio compression requirements under European Market Infrastructure Regulation (EMIR): Under EMIR, the banks are obliged to reduce their derivatives portfolio on a regular basis by dissolving transactions which are opposing each other. This may in principle also

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concern those transactions which, as external transactions, are opposed to the IRT transactions if, for example, another external transaction of the trading book is netted out with such a transaction. The requirement to assign an identical external transaction to the IRT transaction would in that case no longer be met by the netting.

Moreover, it has not been stipulated how old transactions whose internal risk transfer (based on sensitivities) already exists are to be treated in the light of this option. It has been a common practice to hedge such transactions by entering into external counter-transactions which, however, are not an exact match. Therefore, a transitional provision has to be made for existing transactions which does not make it necessary to dissolve all existing hedges which are economically reasonable and to execute new, slightly different hedges in order to obtain an exact match. Cancelling those internal transactions and then executing slightly different new transactions in order to reproduce external hedges exactly is not acceptable to us as a solution to this problem. As a result of this, risks which have existed so far due to inexact matches of IRT and external counter-transactions and had to be backed in the trading book so far would now materialise in the banking book as difference between the original transaction and the IRT.

Option 1 refers to paragraphs 191 to 194 which are said to relate to the banking book exposure. However, in the text of the regulation according to the Basel III monitoring exercise, the paragraphs referred to concern other issues or do not exist.

By contrast, an internal risk transfer into the trading book actually takes place in **option 2**. However, the specifications of option 2 do not correspond to the current market practice not hitherto objected to by the supervisory authorities.

- At the moment, in order to hedge an internal risk transfer into the trading book, a new external counter-transaction is typically not necessarily carried out and, in the internal portfolio control, the internal transactions are treated in the same way as external transactions. The specifications of option 2 would compel the banks to depart from this good practice. As a result, the specifications would act as incentives for hedging both risk which are inherent to the trading book and risks transferred from the banking book by an external counter-transaction, in order to reduce the equity coverage required according to banking supervision rules, even if neither of the two transactions would have been necessary from an economic standpoint. This would lead to significant additional external market activity and hence increased counterparty credit risk exposure. This may be accompanied by higher market and counterparty credit risks which would have to be appropriately monitored and managed. In extreme cases, external self-dealing between the two portfolios of the trading book would occur when trading via trading platforms.
- What is more, the separation requirements would mean that diversification advantages with exiting positions in the individual trading book portfolios would no longer be possible. As has been described above, it would be decided separately for each of these two portfolios whether to enter into an external counter-transaction. This may lead to the situation that the open risk position is hedged in one of the two trading book portfolios but not in the other. In this case, the intended reduction of the equity coverage would be accompanied by an increase of the economic market risks, which cannot be the aim of the regulatory requirements. As a consequence, the specifications would have considerable negative side effects which, in our judgement, are not offset by potential regulatory advantages.

It is, therefore, our opinion that in particular the prohibition to offset risks existing in the original trading book with the internal transactions should be dropped. Moreover, we request confirmation that issuance

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of an internal ticket is sufficient documentation for the purpose of internal risk transfer. We do not expect any value added to be generated by the explicit description of the source of a risk.

Option 2 is admissible only for the transfer of general interest rate risks (GIRR). However, we see no reason for excluding in particular interest rate, credit and share risks and, therefore, demand to make option 2 available also for all these risks.

In this respect **both options** are not ideally suited as being the only solution for all banks. We therefore suggest to offer banks a choice between the two proposed options. Banks might commit themselves in advance, which option they would apply for each single sub-portfolio. This would enable banks to bring regulatory and economically viable management of their risks fairly in line.

2. *Standardised approach*

a) General comments on the standardised approach

We support the Basel Committee's decision to now exclusively pursue a sensitivity-based approach. We also basically support the refining of the methodology by introducing additional risk factors, which is necessary due to the new approach. We believe, however, that the Basel Committee has - to some extent - “overshot the mark” (see the detailed explanations on this below). This is in particular true where the differentiation between the individual risk factors goes even farther than is the case in the majority of the banks using internal models.

The proposed standardised approach is to be rated as a delta-plus approach in conjunction with a variance-covariance approach, and hence has turned out to be very close to a model. Although this makes sense, it also involves dangers. For example, it has to be assumed that when the standardised approach is implemented by model banks, the implementation will be in accordance with their own model implementation. This actually is reasonable due to consistency and bank-internal comparability and would probably concern the internal pricing tools, but also the selection of the risk factors (e.g. no precise specification of the number of the interest rate curves in the case of GIRR). Ultimately, this may also lead to a variance of the results in the standardised approach which might restrict the comparability between banks and also concerns the definition of floors. This requires particular attentiveness.

Moreover, we welcome the Basel Committee's proposal to newly introduce the correlation method as a so-called “baseline method” to take account of basis risks. We agree that larger banks with extensive trading activities will primarily implement the correlation method. That method substantially better corresponds to the internal control processes of larger banks than the disallowance factor method.

The basis risk correlation parameter provides that the correlation coefficient between the pillars of two interest rate curves will be multiplied with the factor $(1 \pm x)$, with x being set to 0.1% for almost all asset classes in the current proposal. The introduction of this factor, which is to take account of the basis risk, means that the results become more risk-sensitive than if the disallowance factor is used, without considerably increasing the complexity of the calculation. Another increase of the risk sensitivity could be achieved if the factor were not uniformly calculated with $x = 0.1\%$, but varied in dependence on the asset class. Smaller banks might encounter problems with the calculation of the sensitivities towards all regulatory risk factors because the technical infrastructure is not sufficient. Here, proxy sensitivities might help where, in certain cases, calculation towards a certain risk factor is not possible. Nevertheless, in addition, the disallowance factor method should be available at least to smaller banks because that

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method presents fewer challenges to the banks. In so far, we support the Basel Committee's considerations to also take into account a low trading volumes and specific risk factors.

We assume that the parallel calculation of the standardised approach proposed in previous consultative papers for model banks as well can be intended only based on the respective method used internally for the basis risks. Parallel calculation according to two different standardised approaches would be extremely burdensome, and cannot be accepted by any bank.

While a basis can be observed between single-name CDS and index CDS in the case of relative illiquidity of the former, such a basis cannot be demonstrated between shares and share indices (as ETF, future or forward) or commodity futures and commodity index futures. The market convention clearly is the trading of the index at the price of the sum of the single underlying prices. Therefore, a look-through approach for the purpose of disclosing basis effects is not necessary.

Since a general look-through for indices would be associated with very high costs for a very small benefit, including the creation of up to 500 risk factors per index and the procurement of the associated market data and the calculation of all sensitivities on a regular basis, the relevant requirement should be cancelled.

This goes all the more for the look-through requirement regarding funds in the trading book. In contrast to market indices, the large majority of funds disclose their investments only at the periodic reporting dates. Since this is true also for the largest and most liquid of them, the implication is that no conclusion can be drawn from the availability of a look-through to the liquidity of a fund.

Therefore, based on the current presumptive list, an intention to trade might not be presumed even for the largest and most liquid funds and derivatives, and they would have to be reported in the banking book. This is a clear contradiction to the current market practice.

Moreover, we would like to point out that the preparation of the banking book risk infrastructure for the sometimes complex fund derivatives (e.g. structured and/or barrier-determined products) would entail very high capital costs.

The capital requirements for securitisation exposures in the trading book that are assigned to the non-correlation trading portfolio are significantly too high in the standardised approach. This holds true in particular for well-established high quality ABS with triple-A rating such as auto-ABS and likely to exceed those of the banking book. This does not seem appropriate in view of the relatively short holding period in the trading book and will be detrimental on holding ABS position in the trading book with adverse impacts on the liquidity of such instruments. Therefore, at least a cap should be introduced that limit the capital requirements for securitisation position in the trading book to the capital requirement of the banking book. While it is to be welcomed that double counting on default risk should be avoided it is not sufficient to set the maturity to one year, since this implies that top prime ABS are charged with the floor capital requirement in the banking book. However, according to the securitisation framework of the Basel Committee published on 11 December 2014, the floor risk weight will increase from 7% to 15% which is a bit more than a doubling of the current capital requirement in the banking book. In addition, the risk weights for spread risks of high-quality top-rated securitisation positions that have to be assigned to the non-correlation trading portfolio are much too high as well. One reason might be that in contrast to the second consultative paper the Basel Committee has stopped using the rating grades and only differentiates between investment and non-investment grade. This is not risk-sensitive and appropriate for top rated high quality ABS. Hence, the investment grade segment should at least be further

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differentiated between highly rated ABS with triple A and double A rating on the one hand and other ABS with a rating that is commensurate to "investment grade" on the other hand.

Furthermore, the work of the Task Force of the Basel Committee and IOSCO as to simple, transparent and comparable securitisations should be used to significantly lower the risk weights for qualifying asset backed securities in the non-correlation trading portfolio. This also seems justified as simple, transparent and comparable ABS that are well-established in the market exhibit significant lower spread risks as a complex, difficult assessable securitisation tranches.

Our comments on the details of the respective text numbers are given below.

b) Specific comments on the standardised approach

Text number 7

We welcome the fact that direct offsetting of the sensitivities is permitted. The treatment of offsetting is considerably simplified by discarding the previous position where a full offsetting was only allowed in the case of the same instruments and the remaining positions could only be offset with a disallowance factor.

Text number 10

We also endorse the fact that for the curvature risk for interest rate curves the entire interest rate curve is shifted simultaneously, so that no unrealistic interest rate curves are created, based on which options have to be valued. Likewise, summing up across all instruments prior to establishing the minimum makes sense because this leads to a better offsetting of opposing positions. This proposal simplifies the calculation of curvature risks and in this way avoids potential inconsistencies such as negative forward rates.

However, the meaning of the curvature risk factors is not clearly defined for the GIRR (cf. text number 11). With respect to the GIRR, we believe a single shift per currency is appropriate because this does not lead to unrealistic, inverted basis spreads (e.g. between EONIA and Euribor), and basis risks are already sufficiently covered by the delta risks.

The formula provided for GIRR and CSR in 10a is misleading:

- x_{it} and RW_{it} are not depending on the instrument i and, therefore, the index i should be stated at V .
- The sum over i should extend over the entire line and, therefore, appropriate brackets should be inserted.

As an example, the upper component of the minimum function should be as follows, with the two corrections:

$$\sum_i [V_i(x_t + RW_k \forall t \in k) - V_i(x_t \forall t \in k) - \sum_{t \in k} RW_k * s_{it}]$$

In the formula for the other risk types as well, the index i should be stated at V and not at x and RW .

The formula for the calculation of the capital requirement from curvature risks (10 c) is not unambiguous because it contains a correlation parameter $\rho_{k,l}$, which according to Section 5 depends on the

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supporting point. However, the CVR used are calculated for a complete curve. A calculation example would establish clarity.

Text number 11 et seq.

We appreciate that the delta risks and curvature risks are to be treated analogously.

Text number 14

In the context of a standardised approach, we think it is excessive to use dividend estimates for all shares as risk factors. Firstly, their influence on option prices (and only there do formulas exist for the connection anyway) is rather small and, secondly, there is no reliable market data on this.

Moreover, we do not fully understand what “equity repurchase agreements” means. Are these the interest rate spreads included in the option pricing formula (distinguished by shares)? In this case, we think that an inclusion is causing too much cost for a standardised approach.

Text number 17

In our opinion, the allocation into time-dependent buckets for instruments with several currencies only is reflecting the risk just incorrectly. For example, if a foreign currency loan or a foreign currency deposit is hedged by means of a cross-currency swap, the exchange rate risk is eliminated from the economic point of view. However, while for the loan or the deposit all cash flows can be assigned to the same bucket, the cash flows of the cross-currency swap would be taken into account in different buckets. This results in an open position.

Furthermore, foreign currency payments are internally discounted with the foreign currency interest rate, and a sensitivity of that present value to the exchange rate of the reporting currency is determined. Accordingly, allocating the foreign currency sensitivities to three buckets would not at all be possible or would require a massive change of the pricing methods contrary to what is customary in the market. In so far, we suggest dropping the bucketing here.

The concern expressed in the consultative paper that without multiple foreign currency buckets the risks of cross-currency swaps might not be appropriately reflected could, in line with the market standard, be accounted for within the general interest rate risk by introducing cross-currency swap-spread curves in the form of additional interest rate curves.

Moreover, we would like to point out that in particular the capitalisation of the foreign currency risk position should be kept as simple as possible in terms of methodology and procedure because that amount has to be determined by all banks doing foreign currency transactions, i.e. in particular also by a large number of smaller (non-trading-book) banks. Based on the idea of proportionality, more complex methods should be used rather exclusively for trading-book banks.

Text number 18

For the GIRR, the number of nodes (10 option maturities multiplied by 10 underlying maturities multiplied by 6 moneyness ranges = 600 nodes) for which the vega risk is to be calculated is much too big. This would clearly be asking too much in particular of smaller banks. For comparison: Even model banks are using merely about 100 nodes in their models. Therefore, the moneyness dimension should be dropped. With respect to the maturities, several ranges should be combined or standardised in a reasonable

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manner to further reduce the number of the risk factors. Moreover, the proposed methodology most likely will overstrain smaller banks that exclusively apply the standardised approach.

Text number 20

Already in previous consultative papers we have voted against a strict requirement that par rates have to be used. At least in the German banking industry it is the valid standard to use zero rates as input parameters for the pricing models implemented and as risk factors for risk models. Also against the background of the use test, we propose to not define which type of interest rate curves are to be used. Only in this way inconsistencies with existing methods and expenditure can be avoided.

Text number 31

A relative change of the implied volatility of 134% is presumed. We believe this is clearly too high. Likewise, the relative change is distinguished merely by means of the liquidity horizon, but not by means of individual asset classes. Furthermore, the question arises whether that relative change is to be applied uniformly to both relative and absolute volatilities.

Text numbers 32-33 and 35

We cannot understand the reasoning behind the proposal to apply two different matrices to compute sensitivities with the same and with different signs. Just one matrix is generally used even in internal models. For reasons of consistency, this should also be the case for the standardised approach. Moreover, the inconsistencies regarding the calibration of the two regulatory matrices arising from the introduction of the correlation method can be eliminated in this way. If the purpose of the introduction of different correlations for positions with the same and with different signs is a more conservative determination of the capital requirement, that purpose should be pursued rather in the context of the downstream calibration of the output, to prevent collateral damage in the modelling.

Furthermore, it is not clear whether according to number 35 different maturity ranges shall also apply to the correlation between vega and delta.

In our opinion, provisions should be added how the vega is to be offset along the dimensions of maturity of options or maturity of underlyings and moneyness (if this is not waived as suggested in our comments regarding text number 18). At present, the correlation matrices have just a maturity dimension.

Text number 42

For the calculation of the basis risk, we do not believe it to be reasonable to make a distinction between whether an instrument is part of an index or is concluded individually. There is no basis risk between a share as an instrument and as part of an index, cf. also the argumentation at the end of Section 2a).

Text numbers 38-45 and 46-59

In contrast to the second consultative paper, credit spread risks of securitisations and non-securitisations are now treated uniformly, which we welcome. This is possible because the sensitivity-based approach and the look-through for indices are used instead of the cash flow approach. The distinction is made at the risk weights. For a conservative determination of the capital requirement, an additional parameter has been introduced for the basis risk, which is $x = 100$ basis points. However, in number 49 it is not obvious to which correlation matrix the value x is to be applied. An example might clarify this. In text numbers 12

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and 13, it is provided that the risk factors for the credit spread risk are to be assigned based on maturities (1Y, 2Y, 3Y, 5Y, 10Y). In our opinion, however, the treatment of the different maturities is not consistently designed in the consultative paper.

The risk weights are significantly too high for highly rated securitisation positions with triple A and double A rating. One reason might be that in contrast to the second consultative paper the Basel Committee has stopped using the rating grades and only differentiates between investment and non-investment grade. This is not risk-sensitive and appropriate for top rated high quality ABS. Hence, the investment grade segment should at least be further differentiated between highly rated ABS with triple A and double A rating on the one hand and other ABS with a rating that is commensurate to “investment grade” on the other hand. In addition, we assume that the calibration of the risk weights was highly influenced by the sharp increase of credit spreads during the last financial crisis. However, this was mainly due to fire sales of highly leveraged SIV's that have disappeared. Thus, the work of the Task Force of the Basel Committee and IOSCO as to simple, transparent and comparable securitisations should be used for qualifying securitisations to significantly lower the risk weights for asset backed securities in the non-correlation trading portfolio. This also seems justified as simple, transparent and comparable ABS that are well-established in the market exhibit significant lower spread risks as a complex, difficult assessable securitisation tranches.

Text number 77

According to the consultative paper, a distinction by “maturity differences” shall be made to compute the basis risk of commodities. However, the risk factors are defined in text number 15 exclusively in relation to the spot price.

Text number 105

While it is to be welcomed that double counting on default risk should be avoided it is not sufficient to set the maturity to one year, since this implies that top prime ABS are charged with the floor capital requirement in the banking book. However, according to the securitisation framework of the Basel Committee published on 11 December 2014, the floor risk weight will increase from 7% to 15% which is a bit more than a doubling of the current capital requirement in the banking book. Thus, the capital requirements for backing the default risk should be reduced. This holds true in particular for securitisation positions that qualify as simple, transparent and comparable, because the model and structural risk that was used as a rationale to increase the capital floor is much lower for this kind of securitisation.

3. Internal model approach (IMA)

We welcome the simplified new regulation regarding the incorporation of market liquidity risks by means of an upscaled base liquidity horizon of ten days. This is a simplification and avoids the statistical problems of the specifications in the second consultative paper.

However, the distinction made between given liquid currency pairs and other pairs does not make sense for foreign exchange rates because, firstly, probably most banks will not have set up all exchange rate pairs as risk factors but, for reasons of consistency, only those that include their home currency, and, secondly, the fiction of just individual liquid pairs is inconsistent in itself. For example, if you have South Korean won (KRW), they are, according to the specification, liquid towards the USD, and the USD is liquid towards the EUR. So, according to that fiction, as a EUR bank you can quickly close your KRW

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position via the USD-diversion. However, KRW/EUR is (probably even rightly so) not specified as a liquid currency pair. It would, therefore, be more reasonable to specify currencies which are liquidly traded (possibly via the USD-diversion) and not to specify currency pairs. If the proposed definition based on currency pairs were maintained, although most banks have rather set up the exchange rates to the home currency as risk factors, this would result in a unilateral preference of US banks because substantially more currencies are rated as liquid towards the USD and, accordingly, less capital would be required.

Moreover, we continue to see as very critical the introduction of the so-called risk assessment tool as the third, equal-ranking, validation tool besides back-testing and the P&L attribution process, and as a tool for identifying desks with illiquid products.

It is not evident that the aim of identifying desks with complex, potentially illiquid instruments with an increased model risk or with a special danger of “jumps in liquidity premia” (JILP) can be achieved by using such a tool. A low “risk density” may have many comprehensible reasons and, apart from that, is not necessarily indicative of modelling problems. It is entirely sufficient to use the two aforementioned tools to identify desks suitable for the internal modelling. In so far, the specifications made here should be cancelled.

The risk assessment tool also competes with the planned floor, without it being clear why both tools in combination should lead to consistent results. However, a final assessment of this tool, which obviously is regarded as very important, is currently not possible because an exact specification is still missing.

The requirement of availability of real prices for risk factors assumed to be modellable, which is currently made in the context of the IMA, only allows the use of real transaction prices or committed quotes for the time series on which the modelling is based. For a large number of risk factors, the current modelling is done by means of external time series which are based on non-committed market quotes. In particular for OTC products, due to their character, it is impossible for an individual bank to gather the necessary number of “real prices” by itself.

We believe the reason for the strict formulation of the requirement are the price manipulations of publicly available quotes which have occurred. However, with respect to manipulability, they are not comparable to the external data used by, e.g., MarkIT or SuperDerivatives. From a realistic point of view, the deliveries by the market data providers are much more difficult to influence even with price-fixing, due to the large number of contributors and downstream validation stages.

On the other hand, a traded price may be manipulated without much effort, in particular since no minimum has been defined for the necessary volume of price-defining transactions.

The situation is similar in the case of committed quotes. On most market platforms, final manual confirmation is intended even for these (although often the so-called hit ratio is checked here internally, it is in the end not made public by the platform). Accordingly, they are not the desired equivalent to actually traded prices and might actually rather easily be used to create manipulated time series.

Therefore, the use of validated external market data can provide a much better protection against price manipulations than the use of traded prices or committed quotes. We hence propose to allow the use of external market data from dedicated providers in addition to the existing requirements.