



Group Risk

3 October 2008

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

33 Old Broad Street
London
EC2N 1HZ

Direct Line:
0207 788 2213
Fax No:
0207 788 2200

Email:
katewatsonl@HBOSplc.com

Dear Sirs

Re: Guidelines for Computing Capital for Incremental Risk in the Trading Book

We welcome the opportunity to comment on the Consultative Document "Guidelines for Computing Capital for Incremental Risk in the Trading Book".

HBOS is a UK bank with over 70,000 employees, is a major UK provider of mortgage finance and operates in a number of jurisdictions. To support its banking businesses it runs treasury trading operations in London and Sydney and has FSA CAD2 model approval for general market risk.

HBOS Feedback

1. The introduction of another model regime – on top of VaR, IRB and AMA - will constitute a further significant major cost overhead on firms and regulators. The design, build and validation of the envisaged models will constitute a major undertaking and will consume scarce industry resource that, arguably, might be better directed to managing and mitigating the direct risks rather than perfecting a capital number which will ultimately still be driven (in part) by subjective judgments. If the end objective is to achieve a level of capital roughly equal to that which would apply to similar portfolios held in the banking book, a far simpler approach would be, for regulatory capital purposes, to apply the banking book capital framework for those positions that the regulatory authorities judge to be too illiquid to qualify, either temporarily or permanently, for normal trading book treatment.
2. An unintended consequence of the approach might be that firms, in order to avoid the additional overheads (with little offsetting capital benefit), would unilaterally transfer relevant positions to the banking book. While the capital objective would be achieved, the other advantages of firms holding de facto trading positions in trading books – particularly the transparency of daily mark to market valuation – would be lost.
3. The establishment of a level playing field by the regulatory authorities is likely to be a major issue given the complexity of models and the long lead time it will inevitably take for each to be individually assessed.

4. The inherent difficulty of validating projected one year 99.9% confidence outputs against observed daily p&l volatility will reduce greatly the likelihood of the measure aligning, in practice, to how (in normal market conditions) trading books are actually managed. The need for firms to meet an, as yet unspecified, "use test" is therefore likely to be a major management distraction. While the models should, in theory, inform senior management understanding of risk, an over complex model could have the exactly the reverse effect, particularly if its final outcome is predicated on an assumption that it should roughly equate to the banking book charge.
5. The boundary between specific risk VaR and IRC is not clear. While the latter clearly includes significant elements not in the former, it would be helpful to have an explicit statement of what it is envisaged specific risk would include and what IRC would not. Until this is clear it is difficult to comment on the issue of double count.
6. Finally, the events of the last 12 months have demonstrated that the level of VaR based capital has proved inadequate to withstand the impact of unprecedented market stress and, with hindsight, should have been somewhat higher particularly for credit instruments. However, going forward, there would seem to be equal systemic dangers associated now with erring too much in the other direction and constructing a regime that is overly calibrated to abnormal conditions. If the capital costs associated with undertaking a trading operation are set too high, this could act as a barrier to firms re-entering the market and thus, as an unintended consequence, could actually delay the return of normal market conditions. A more proportionate and less onerous approach would be either to apply higher prescriptive multipliers in respect of specific risk, possibly differentiating between different asset classes based on their perceived liquidity characteristics or simply to apply banking book treatment for positions deemed too illiquid. This would allow regulatory attention to be directed more towards prudential valuation rather than on the minutiae of probabilistic measurement of future outcomes which, over the longer the time horizon considered, become progressively less likely to be realized.

If you have any further queries on our response please contact Paul Newson on telephone number 020 7788 2206.

Yours sincerely

Bob Brooks
Head of Balance Sheet Risk