



Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室
電話：2521 1160, 2521 1169 圖文傳真：2868 5035
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

17 February 2015

By email: baselcommittee@bis.org

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

Dear Sirs

**Consultation Document on Fundamental Review of the Trading Book:
Outstanding Issues (December 2014)**

We refer to the consultative document on “Fundamental review of the trading book: outstanding issues” issued by the Basel Committee on Banking Supervision (BCBS) in December 2014. On behalf of our members, we set out in the annex our detailed comments on the proposals in the consultative document.

We hope you find our comments useful. For any questions, please do not hesitate to contact Ms Emily Ngan of the Secretariat at (852) 2526 6080.

Yours faithfully

Henry Chan
Secretary

Enc.

c.c. Ms Karen Kemp, Executive Director (Banking Policy), Hong Kong
Monetary Authority

Chairman The Hongkong and Shanghai Banking Corporation Ltd
Vice Chairmen Bank of China (Hong Kong) Ltd
Standard Chartered Bank (Hong Kong) Ltd
Secretary Henry Chan

主席 香港上海滙豐銀行有限公司
副主席 中國銀行（香港）有限公司
渣打銀行（香港）有限公司
秘書 陳崇禧

Annex: HKAB's comments on the BCBS Consultative Document

Fundamental review of the trading book: outstanding issues (Dec 2014)

The third consultation paper of Fundamental Review of Trading Book ("FRTB") made some refinements to the proposed market risk framework since October 2013, including:

- the treatment of internal risk transfer of equity risk and interest rate risk between the banking book and the trading book
- the adoption of a sensitivities-based methodology (SBA) in the revised standardised approach and
- the incorporation of a simpler method on the concept of liquidity horizons in the internal models approach (IMA).

This consultation re-emphasises that the BCBS intention is to create a globally consistent supervisory framework by harmonising criteria for Trading Book inclusion. However, two major areas drawing greater attention from the industry are not covered in this third consultation paper, namely a) Desk Structure and b) Trading Book / Banking Book (TB/BB) boundary. We would like to highlight that the original proposals may lead to different National Authorities taking different interpretations resulting in regulatory inconsistency, increased implementation difficulties and distortion of market pricing (please refer to the below for details).

In light of the large number of outstanding concerns expressed in this letter, and the degree of uncertainty surrounding the capital impact, we believe that more time is needed beyond end-2015 to finalise the FRTB policy framework. If material issues are unearthed during the subsequent two-year calibration period (2016-2017), it will be difficult to resolve these without reopening the already completed framework.

A. Application of Desk Structures within a Bank Group subject to multi-national authorities

Regulatory consistency across jurisdictions is a prerequisite to ensuring that financial institutions can offer cross border services without unnecessary complexity and that customers can benefit from these. For a large cross-border institution, which is present in a number of different jurisdictions, it would be subject to the requirements of many national competent authorities.

With regards to FRTB desk structure, we are concerned that institutions may not have sufficient flexibility to determine their structures in a way that maximises efficient risk management practice and simultaneously ensures compliance with pre-existing regulatory requirements. Although FRTB proposals allow banks to define their trading desk structure, supervisors must approve whether the proposed structure is sufficiently granular. We would argue that a granular desk structure is not a pre-requisite for a well-defined business strategy or a clear risk management structure. On the contrary, an overly granular trading desk structure will often be less efficient. US Volcker rules have,

for example, resulted in a very prescriptive restructuring of trading desks. Should inconsistency arise between jurisdiction and FRTB guidance, Banks may have to work around the desk structure. This will be further complicated by forthcoming structural reform measures such as the Vickers ring-fencing within UK and the structural separation proposals being negotiated in the European Union.

With a bank group crossing multiple geographical boundaries and local legislation, the FRTB desk structure will need to be approved not only by the lead group supervisor, but by every regulator where the subsidiary of the institution is locally incorporated. The hierarchy of approval within a group structure is unclear if without equivalence recognition.

With this in mind we recommend the following:

1. FRTB text should guarantee firms' ability to choose own desk structure, and ensure regulatory coordination for the approval of such structures.
2. Regarding supervisory approval of firms' trading desk structures, reference to granularity should be removed to increase flexibility and reduce the potential for conflict with structural reform measures.

B. Trading Book / Banking Book Boundary

We believe that trading intent should be the primary driver for TB classification. The presumptive lists for selected products should be used only for "general guidance" or after the ability to proof trading intent has proven insufficient or failed (i.e. failure in the three supervisory assessment tools listed in the second consultation). Any deviation from the presumptive list should be subject to supervisory notification, as opposed to approval, to avoid over-burdening new product activity. Such presumptive list should evolve over time to take into account new product developments. Some type of BCBS FAQ feedback mechanism across jurisdictions would help achieve this, while maintaining regulatory consistency.

We also support clarification in FRTB proposals that the designation of a given instrument to either the TB or BB should be done irrespective of that instrument's accounting treatment, but aligning to the underlying economic risk.

With this in mind we recommend the following:

- Regulatory divergence will also be minimised by ensuring trading intent takes precedence for TB/BB classification with the presumptive list to be considered only in the second instance as guidance rather than a binding requirement.

Other outstanding concerns with the FRTB framework

- **Incremental Default Risk Charge (IDRC)**

Unlike Expected Shortfall (ES), the IDRC does not appear to differentiate liquidity horizons for different underlyings, e.g. large cap vs small cap equity, investment grade sovereign vs high yield corporates. We would like to seek the Committee's guidance for dealing with liquidity horizons within the IDRC.

Additionally, including equity significantly increases the complexity of the calculation. Equity products are often highly-structured and linked to indices. Estimating capital linked to single name default risk for such products is highly challenging and at least, if not more, complicated to compute than the current Comprehensive Risk Measure (CRM) for the Correlation Trading Portfolio. Furthermore, equity trading is not typically managing default risk and is rather managing price risk. Given this, and that equities are listed, we recommend the IDRC scope does not include equity.

Finally, as mentioned in the last consultation, the proposal to have the probabilities of default (PDs) of all obligors subject to floor of 0.03% is not justifiable. In the internal rating based approach for credit risk, the floor on PD is only applicable to corporate and bank exposures. Sovereign exposures are exempted from the floor on PDs. Applying a floor on sovereign exposures would result in an inconsistent measurement of default risk between trading book and banking book and create opportunities for capital arbitrage. Moreover this is overly conservative and not supported by empirical evidence.

- **Data Availability**

We are concerned that for some markets, in particular those like Hong Kong where a significant portion of financial markets activity is linked to new onshore/offshore products, 'real data' may not be available to build a sufficiently long time series. This will be particularly problematic as QISs require risk factor data for a reduced portfolio with a minimum observation history of 10 years.

For some products – such as China offshore spot (CNH) products – the USD-CNH currency was introduced only in 2010 but since that time has experienced high levels of liquidity.

We would recommend that conditions on observation history be revisited for the reduced portfolio so as to not unnecessarily disadvantage these burgeoning markets. More specifically we believe that the conditions described in paragraph 183 c) in the second consultation should be the primary determinants for risk factors to be deemed as 'modellable.' Some amendments are needed to address these new products, specifically for markets like Hong Kong.

- The requirement that a risk factor must have at least 24 observations per year (with a maximum period of one month between two consecutive observations) to

be considered modellable may exclude some new indices that have been traded less than a year. To facilitate the development of liquidity of these new indices, we recommend identifying an appropriate proxy in these cases, with the basis risk to be included as NMRF.

- Similarly, some newer products are in fact a combination of modellable and non-modellable risk factors—in other words the curve would be considered as liquid in the short-term but not in the long-term. In these cases FRTB requires that the entire curve be deemed non-modellable; however, we recommend that on the basis that the long tenors can be proxied, only the basis risk be included in NMRF. This treatment would be consistent with the previous point, and strike the right balance between conservatism and risk sensitivity.

- **Desk-by-desk approach**

The new desk-by-desk approach adopted by the FRTB framework presents several challenges for firms, and has the potential to increase overall RWA volatility.

- **Treatment of Desk Level Tests**

Due to stringent validation constraints, the possibility of a given desk being fallen back to SBA is more likely. Were this to happen, any trades carried out between the SBA desk and IMA desk would become less efficient and may result in broken hedges. This increase in volatility will translate into more expensive hedges for clients and more volatile capital requirements.

Also, from an operational perspective, the Committee has not made clear the process governing the transition from IMA to SBA and back again. To avoid excess volatility and allow firms to have a grace period to remediate modelling issues, we recommend consideration be given to a smoother transition process.

- **Back testing and P&L Attribution**

The use of desk-level P&L attribution to determine model eligibility is a relatively new concept and we strongly recommends that it be tested thoroughly before this is enshrined in the final FRTB framework.

- **Public Disclosure of Desk Structure**

Under the second consultation framework, the institutions are required to disclose the following with increased frequency:

- Explanation of drivers for change in period to period
- A more granular and consistent segmentation at desk level
- A more frequent disclosure (will be quarterly or half-yearly, instead of annually)

- Disclosure of key modeling choices
- Disclosure of key differences in models used for internal risk management and those used for regulatory capital calculations
- Disclosure of SBA and IDRC at the desk level

The excess disclosure may be counter-intuitive, highly dependent on how granular the desk level information is required to be disclosed and how the changes are to be explained. Sensitive information (e.g. trading strategy, the positioning and size of trades) may easily be misinterpreted by the public.

Based on the proposed framework section 4 disclosure requirements, we understand that the Committee is considering to increasing the frequency of Market Risk disclosures. Public disclosure risks revealing proprietary information about firms' trading strategy, which risks undermining competitiveness and at the very least will create noise and/or market volatility. We would recommend Pillar 2 supervisory disclosure at the desk level.

Here below is our response on this third consultation.

1. What are your views on the specific refinements described in the three sections of this consultative document?

- **Internal Risk Transfer**

Normally, the trading book would obtain funding from the banking book (e.g., for the Bond Trading, and Onite FX Swap cash flow management). We would like to seek clarification from the Committee on the treatment for this kind of funding deals. We recommend this kind of funding deals should be recognized and included in the market risk capital charge calculation in order to align risk and capital charge.

We would like to seek clarification from the Committee for the sentence in paragraph 39, “there will be no regulatory capital recognition for internal risk transfer (IRTs) from the trading book to the banking book” means the IRT from the trading book to the banking book would be excluded from the market risk capital charge calculation.

The term “eligible third-party protection provider” is used in credit (paragraph 39a), equity (paragraph 39b) and GIRR option 1 IRT treatment (paragraph 39c), while the term “third party” is used in GIRR option 2 (paragraph 39c). We recommend a clear definition on these terms should be included.

In paragraph 39b, the IRT of equity risk exposure needs to meet the requirement vis-à-vis the banking book exposure. We would like to seek clarification from the Committee on the detailed requirements for IRT of equity risk exposure.

We are of the view that option 1 for IRT on GIRR should be implemented in order to have a consistent approach for IRT on different risk types provided that a more clear guidance on the requirement should be included in the rule text.

In respect of the option 2 for IRT on GIRR, we recommend a more clear guidance should be given on the details of documentation, approval process and requirements, definition of recognised type of hedge for a banking book interest rate risk exposure. We also propose to have supervisory notification, as opposed to approval, to avoid over-burdening new hedging activity.

- **Revised Standardised Approach for Market Risk**

Equity Risk Factors [Page 24]

We would like to seek clarification from the Committee on whether the repurchase agreement (repos) for equity risk factors in paragraph 24 refers to repo rate.

Equity Risk Sensitivities [Page 26]

In paragraph 23, it is unclear which equity risk factor (spot prices/dividend forecasts/repo rates) does EQ_k refer to. We recommend to omit the dividend forecasts/repo rates as institutions need to invest heavily to get such figures and the marginal benefit is minimal.

Definition of “Risk Free Yield Curves” [page 23]

We would like to seek clarification from the Committee on the definition of “risk free yield curves” in paragraph 11. We recommend clear definition of risk-free curve and clear instruction on how to construct such curves (e.g. by overnight index swap (OIS) or swap rates) should be given in order to achieve the “comparability” objective. OIS rates are not available for all currencies (for some currencies there are no OIS and for some currencies OIS rates exist only up to 1-year), this should be noted when considering the construction of risk-free curves.

GIRR Sensitivities [page 25]

Please provide an illustrative example on the calculation of GIRR sensitivity to the risk-free rate for interest rate derivatives

CSR Sensitivities [page 26]

We would like to seek clarification from the Committee that only Bonds/CDS/Credit derivatives are subject to credit spread risk (CSR), and the non-credit derivatives (e.g., IRS, FX Forwards, FX Options,..) are not subject to CSR. If the non-credit derivatives are subject to CSR, please clarify the definition of the parameter, credit spread on tenor t (cs_t). This is not intuitive for derivatives. We recommend numerical examples of various products should be given.

Treatment of Inflation-Linked Instruments [page 23]

The GIRR delta risk factor includes a flat curve for risk-neutral inflation rate for each currency according to paragraph 11 of Annex 1. When calculating PV01 of inflation-linked instruments using the formula in paragraph 20, we would like to seek clarification from the Committee that whether the parameter, risk-free interest rate curve at tenor t (r_t), should refer to “flat curve of risk-neutral inflation rates” stated in paragraph 11.

We would like to seek clarification for inflation-linked instruments, only one PV01 (by shifting the inflation rate) for GIRR is required and the PV01 (by shifting the risk-free rate) is not required.

“Stick Delta” Approach [page 27]

The paragraph 26 of Annex 1 requires that institutions should assume the implied volatility remains constant when computing the first-order sensitivity. We consider that institutions would encounter difficulties in implementation due to that in many treasury systems implemented; the volatility surface is in delta-

space instead of strike-space. We recommend that the SBA should allow bank to choose to calculate the options PV01 by (1) closed-form; (2) full-revaluation but relaxing the unchanged volatility constraint; or (3) as suggested in the Annex 1 in the consultation.

Calculation of Sensitivities [page 27]

The proposed method for calculating the sensitivities in paragraph 27 of Annex 1 are all by the finite-difference. For options, some systems may adopt close-form Greeks, or the step-size of the finite-difference method is not the same as required in the Annex 1. We suggest that the BCBS should allow flexibility to institutions in choosing the method of calculating the sensitivities. Moreover, for PV01 of GIRR, we recommend the option of using zero PV01.

Cross currency swap treatment under SBA [Page 14]

The cross currency basis should be captured in GIRR. Basis rates could be one of the GIRR risk factors. Allocating FX exposure to different time buckets is not the current practice of FX risk management and it would put huge operational difficulty to institutions.

Calculation of curvature [Page 12]

Calculation of curvature does not give any capital benefit for firms whose trading strategy is to be Gamma long (in other words those who adopt conservative strategies). No capital benefit recognized for cases where positive gamma offsets delta risk, which may encourage reduction of hedging for capital benefit.

This effect is particularly distortive for bounded payoffs (e.g. bonds, barriers, digitals, and tranches) which can be misrepresented with a separate delta and curvature capital resulting in a total capital greater than max loss possible.

Single risk weight used across all currencies

Pegged and managed currencies have a far lower volatility than for example free floating emerging market currencies. Applying a risk weight of 15% for all exposures does not differentiate: e.g. 1y implied volatility of USD/SAR is around 1%, however USD/RUB is around 40%.

- **Liquidity Horizons under IMA**

This consultation allows firms to floor liquidity horizons for the ES calculated at Desk level (used for reporting purposes) in an attempt to help resolve concerns with broken hedges. However when the calculation is aggregated at the asset and then entity level it is not clear how this will be dealt with.

Additionally, the current proposal can have large cliff effects when certain risk factor migrates from one liquidity horizon bucket to another bucket due to large gap between liquidity horizon buckets. We recommend reducing the square root

of time lever for longer horizons to reduce differentiation between assets at shorter/longer horizons.

In the paragraph 3.2.2 Floored liquidity horizons between correlated risk factors, we would like to seek clarification from BCBS on the practical application of the methodology. We would appreciate if a numeric illustration could be included.

In the paragraph 181(k) of the proposed text, the footnote 3 should correspond to the risk factor category, “FX rate – liquid currency pairs”.

We would like to seek clarification on the treatment of offshore equivalent currencies. For example, USD/CNY is defined as liquid. It would then be expected that USD/CNH (renminbi deliverable in HK) and USD/CNT (renminbi deliverable in Taiwan) should be treated equivalently.

2. Do these specific proposals strike the right balance between simplicity, comparability and risk sensitivity?

This consultation paper represents a step forward in addressing this balance. However, there still remain some critical issues which prevent us from stating that the right balance has been struck.

In terms of comparability, it is noted that there are some fundamental areas that can still lead to national discretions / regulatory inconsistency. As we have touched upon earlier, this includes definition of desk structure and TB/BB boundary.

Whilst we welcome the adoption of the Sensitivity-Based Approach (SBA) for the standardised approach, there still remain issues with its formulation. This notably includes the disaggregation of delta and curvature which materially compromises the effectiveness of the risk representation. Given the complexity and the significant effort that would be required to implement SBA in its current form, unless the formulation is refined further then we believe the right balance is yet to be achieved in this regard.

In addition, the overall FRTB framework will significantly increase the regulatory reporting burden to institutions, including the regular monitoring on trading intent activities at desk level, the increased disclosure requirements, etc. More generally, extensive system enhancement and increased data processing capacity would be required to calculate and report both IMA and SBA charges. The cost of implementation appears to outweigh the marginal risk management benefits.

More importantly, we are uncertain of the way ahead as impacted by the constraints laid upon institutions’ internal models, and whether institutions should continue to

deploy resources to improve their internal models. When considering the right balance, further consideration needs to be given to the scope and incentive given to firms to improve their risk measurement and management capability.