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

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Dear Sirs,

Subject: Third Consultative Document Fundamental Review of the Trading Book

HSBC welcomes the opportunity to respond to the Basel Committee on Banking Supervision (BCBS) third Consultative Document Fundamental Review of the Trading Book (FRTB).

The industry has submitted papers via ISDA/GFMA/IIF responding to the third FRTB consultation to which we have contributed and fully support. However, there are further issues to which HSBC would like to draw the attention of the Committee. Our high-level observations and views are presented in the body of this letter, while the subsequent annex includes more detailed feedback.

HSBC is one of the world's largest banking and financial services organisations with assets of US\$2,729 billion at 30 September 2014. Headquartered in London, HSBC serves customers worldwide from around 6,200 offices in 74 countries and territories in six geographical regions: Europe, Hong Kong, Rest of Asia-Pacific, Middle East and North Africa, North America and Latin America.

As an internationally active bank we have been generally supportive of the Basel Committee's objectives to simplify and improve capital standards of the market risk framework, as well as harmonise the trading book across jurisdictions and reduce the scope for regulatory arbitrage. However, we would respectfully submit that certain aspects of the proposals will, contrary to the intended effects, lower market liquidity and increase regulatory divergence.

Sound and efficient risk management is of great importance not only to financial institutions, but also to the clients they serve who rely on financial markets for both funding and hedging activities. It is important for the Basel Committee to consider the impact of the FRTB framework on market liquidity and how these proposals may influence the current climate of reduced market liquidity.

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Finally, we are concerned that more time is needed for the finalisation of the FRTB policy framework. The overall capital impact of the FRTB framework for market risk is likely to be quite high, more than doubling for certain business lines. QIS figures to date have according to the Committee been of a very poor quality meaning the capital impact is not fully understood. A third QIS exercise is underway, but with a number of key areas of the framework still being considered we believe further smaller targeted QIS are needed. To achieve this more time beyond end-2015 is necessary.

Regulatory coherence

As a large cross-border institution, HSBC is present in a number of jurisdictions and therefore subject to the requirements of many national competent authorities. We acknowledge and support the goal of the Basel Committee to create a globally consistent supervisory framework by harmonising the trading book boundary determination rules. However, we believe proposals may result in regulatory inconsistency and distortion of market pricing.

We are concerned that a TB designation no longer based on pure ‘trading intent’ which draws on ‘presumptive lists’¹ may result in local regulatory discretion and therein regulatory divergence. This would mean the same instrument could be priced differently between jurisdictions leading to further divergence and inconsistency in regulatory practices. This goes against the Committee’s objective of ensuring harmonisation of the trading book.

Should the Basel Committee believe trading book presumptive lists remain necessary, we would encourage these lists to be seen purely as a fall-back measure where trading intent cannot otherwise be proven. In terms of legal primacy, it is therefore most appropriate that presumptive lists be considered as non-binding guidance.

Another issue we would like to raise relates to trading desk definitions and their compatibility with structural reform requirements. Though structural reform measures will generally not impact market risk capital charges, they will impact the organisation of firms’ trading desks. US Volcker rules have resulted in a very prescriptive restructuring of trading operations. This will be further complicated by forthcoming structural reform measures such as the Vickers ring-fencing within the UK and structural separation proposals being negotiated in the European Union.

Although FRTB proposals allow banks to define their trading desk structure, supervisors must approve whether the proposed structure is sufficiently granular. If supervisors choose to take a conservative view on approving trading desk definitions, firms may be forced into non-compliance with other structural reform measures. We are of the view that a granular desk structure is not a necessary 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. We recommend removing this reference to granularity to increase flexibility and reduce the potential for conflict with structural reform measures.

¹ Paragraph 15 introduces the concept of a trading book ‘presumptive list’ while Paragraph 22 introduces the concept of a similar banking book ‘presumptive list.’

Reviving market liquidity

Although certain aspects of the FRTB are well-intended, it is possible they will further reduce market liquidity and increase volatility. It is acknowledged that the cumulative effect of increased bank capital, leverage and liquidity requirements will be to significantly increase the cost of holding inventory on balance sheet, leading to smaller and less elastic inventories². Banks are therefore finding it more challenging to carry out their role as market makers, supporting primary issuance and secondary trading. Though the impact on liquidity is already visible, accommodative monetary policy has meant the full impact of regulatory change is masked – a point recently emphasised by FSB Chairman Mark Carney³. The cost impact is evidenced by an increase in capital needed to support a hypothetical bond portfolio⁴—under CRR approximately seven times more capital between 2010 and 2014.

Against this backdrop, we would encourage the Basel Committee to ensure FRTB liquidity horizons (LHs) are sufficiently granular and risk-sensitive. The current liquidity horizon calibration, although improved, still relies on risk factor buckets which are too long and overstate the underlying level of risk. Long LHs will mean the inventory of certain business lines, such as corporate bond credit flow desks, may become uneconomic. Perhaps a worry for debt management offices is that trading in sovereign debt will become more expensive. Investment grade sovereign debt falls into the 20 day LH bucket assuming a full month to liquidate these positions⁵. The effects will also be felt for emerging market interest rate and foreign exchange. The capital charge for a portfolio of emerging market interest rate and foreign exchange rate risk⁶ will be roughly 40% higher than the same portfolios for developed markets. Equities which were previously excluded from the Incremental Risk Charge (IRC) now must be included in new Incremental Default Risk Charge (IDRC). This assumes a constant level of risk over a one-year time horizon which is quite conservative in particular for this asset class. Securitisations are another example where exposures will be penalised. We are grateful the Committee is revisiting its treatment of securitisation exposures, and would like to ask that in addition consideration be given to coordinate with efforts in Europe and globally to revive securitisation markets.

² Trading assets down 17% among largest US and EU banks since 2010; Credit Suisse research May 2014.

³ "...Liquidity has become more scarce in secondary fixed income markets. It just appears that it hasn't."

The future of Financial Reform, speech by Mark Carney, 17 November 2014.

⁴ HSBC calculations based on a simplified but diversified portfolio made up of EU sovereign, supranational and agency bonds and swaps (long-term vanilla interest rate risk and cross currency swaps), the introduction of stressed VaR, the Incremental Risk Charge (IRC) and the Credit Valuation Adjustment (CVA) charge, together with the required higher level of capital (for the same amount of RWAs).

⁵ Under previous VaR calculations this was set at 10 days.

⁶ Where a portfolio only contains trades within a single risk factor bucket the formula in para 171c simplifies to $ES = ES(10 \text{ day}) * \sqrt{LH/10}$. A portfolio of developed IR/FX market risk will have a capital charge of $ES(10 \text{ day})$, a portfolio of developing IR/FX risk with exactly the same $ES(10 \text{ day})$ will have a capital charge of $ES(10 \text{ day}) * \sqrt{2}$.

By having a limited set of liquidity horizons for risk factors of 10, 20, 60, 120 and 250 day there is a natural propensity for cliff effects. This will be particularly pronounced in the case of sovereign and corporate credit products where there is downgrade from investment grade to high-yield. In the case of a corporate downgrade from investment grade to high-yield capital charges will go up 40%, while in the case of a sovereign downgrade capital will increase by 73%. We would therefore request that attention be devoted to smoothening out cliff effects and increasing LH granularity between different risk factors and asset classes.

Finally, we would note that because models are now approved and back tested on a desk-by-desk basis, as opposed to at the aggregate trading book level, there is a greater likelihood that desks will 'fail' their back testing requirements and fall onto the standard Sensitivity Based Approach (SBA). This will contribute to higher RWAs, pricing and overall market volatility. In an environment of thin liquidity, this volatility may be more pronounced across financial markets. To remedy this we recommend the introduction of mechanisms to prevent frequent and disruptive transitions from IMA to SBA, such as grace or review periods which allow the firm to mitigate.

Prudential stability and sound risk management

Diversification is a key component to effective risk management and clients will naturally have cross asset class hedging requirements, serviced across multiple desks. These risks can be managed using conservative macro-hedging trading strategies. However, under the advanced Internal Models Approach (IMA) diversification is only permitted within asset classes but restricted across them making these strategies less viable. This is exacerbated by the desk-by-desk SBA approach where no diversification is permitted across desks or asset classes

Similarly, public disclosure at the desk level of the SBA, IMA and the Incremental Default Risk Charge (IDRC) will result in more harm than good. Public disclosure of desk-level information of this nature risks revealing confidential details about a firm's trading strategy that should be considered as proprietary information. Moreover, this level of disclosure will likely not be well understood by the broader market and may create noise and/or increased market volatility.

We understand and support the aim of the Committee to promote greater RWA consistency across banks and achieve comparability of market risk capital charges. However, recognising that this will be a significant undertaking that will require further work beyond FRTB, we believe that supervisory disclosure would be more appropriate at this time.

Timing

The data quality of previous QIS exercises according to the Committee has been very poor, with a number of firms unable to provide inputs for many of the FRTB parameters. Even with its many gaps and inconsistencies QIS results indicate that the overall capital impact will be substantial. A new QIS is currently underway and we are optimistic that these inconsistencies may be addressed; however with a number of key areas of the framework still under development the capital impact of these changes will not be captured. For example, securitisation exposures are not within the scope of the QIS exercise. This is one area of the

framework where it is widely recognised that the current calibration results in double counting and overstates capital.

In light of the large number of outstanding concerns expressed in this letter, and the degree of uncertainty surrounding the capital impact, we believe 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.

Ideally, the next full July QIS would also be used to inform the final FRTB framework rather than calibration only. This would at most require an additional six months until mid-2016 to achieve, which seems reasonable given the scale and importance of the fundamental review at hand.

We thank you for your consideration and for the continued industry collaboration the Basel Committee has provided. We would be happy to answer any questions on the points enclosed.

Yours sincerely,



Samir Assaf

Annex

This Annex draws attention to the following topics of the third FRTB Consultative Document

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1. Internal risk transfer between the banking book and the trading book

HSBC agrees and supports the objective of the TBG to limit capital arbitrage between the banking book and the trading book. We understand that the current IRT proposals do not in any way intend to preclude the hedging of a banking book exposure which we also support. HSBC currently has very limited transfer of risk from the BB to the TB, meaning the impact of these proposals will be limited, if any.

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, but that a more clear guidance on the requirement should be included in the rule text.

2. The revised standardised approach

2.1 Cross currency Basis treatment under SBA

According to the Basel document [1], the rules for the capitalization of FX Delta aim to capture movements in the FX Spot rates as well as cross-currency basis risk. For this, the Delta sensitivity should be allocated in 3 maturity buckets¹ which are then correlated to achieve the total FX capital charge. The cross currency basis should be captured in GIRR via the Interest Rate Parity. Allocating FX exposure to different time buckets creates a double counting of the FX Basis between the FX and the GIRR charges.

2.2 Interest Rates Sensitivity

For the rates sensitivity, the regulation requires the use of yield sensitivities calculated with respect to the risk-free yield curve. Nevertheless, the BCBS document, “Analysis of the Trading Book Hypothetical Portfolio Exercise” from September 2014 shows that approximately 56% of the industry that participated on the QIS1 used sensitivities with respect to the zero rates. Zero coupon is commonly used to manage interest rate risk for some business lines. HSBC therefore recommends having some flexibility in using also zero coupon rates.

2.3 Sticky Delta Sensitivity

The sticky delta needs to be used in the SBA. It makes sense to use the sticky delta convention for the Expected Shortfall computation because it allows one to simulate today’s historical move as a snapshot of an historical market environment. However, the implied volatility is represented with respect to the strike for some market convention. Therefore, the computation of the sensitivities needs to replicate the behaviour of the market dynamic. Computing both sensitivities in sticky delta and sticky strike: one for SBA and the other for risk monitoring, creates a disconnection between capital management and risk management.

2.4 Vega component

Also, the calibration of the vega component can provide more a capital charge that is higher than the premium. For example, considering a 10Y10Y USD swaption straddle the current level:

- Premium = 1400bp
- Vega = 48bps
- Volatility about 27%

¹ The three maturity buckets are: less than 1 year, more than 1 year and less than 3, and more than 3 years.

With a 55% scaling factor, the capital charge become about 1765bp which higher than the premium of the option.

3. Adjustments to liquidity horizons in internal models approach

3.1 Cliff effects

As stated above, proposals 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 (See above Economic impact for more examples). We recommend reducing the square root of time lever for longer horizons to reduce differentiation between assets at shorter/longer horizons.

3.2 Foreign exchange liquidity horizon

While we welcome the increased granularity in the Liquidity Horizons, 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) are equivalently liquid.

3.3 Breakdown of Expected shortfall by risk class for firms using full-valuation

For instruments priced by full valuation, the decomposition of ES by risk class is not possible as a single P&L is obtained which combines all the underlying risk factors.

Thus, to allocate the P&L of each instrument under a specific asset class, banks employing full-valuation must employ several assumptions which can potentially lead to different treatments for the same instrument. The only way to achieve a P&L breakdown by risk class is to use a sensitivity-based decomposition which is currently not permitted.

4. Striking the right balance between simplicity, comparability and risk sensitivity

HSBC is supportive of the Basel Committee's objective of ensuring that a balance between simplicity, comparability and risk sensitivity is struck. However, we believe that there still remain some critical issues within the FRTB framework which prevent us from stating that this balance has been found.

With regard to comparability, as we have touched upon already, certain elements of the proposed framework may increase opportunities for national discretions and regulatory inconsistency. These include definition of desk structure and the use of presumptive lists to determine the trading book boundary.

Public disclosure of desk structure at the desk level, as well as SBA and IMA charges, are another example where aims to achieve comparability go too far. This is particularly true given the granular level of disclosure that is suggested by the framework's proposals on desk definition. Though we appreciate the intentions of the Basel Committee we do not believe that this level public disclosure will deliver value for the reasons stated below.

Similarly, while there is credible rationale for introduction of liquidity horizons their calibration may be challenging because the risk factor definitions across banks may not be the same meaning there will still be differences in how banks interpret the rules. The calibration of liquidity horizons, while improved from previous FRTB iterations, is still lacking in risk

sensitivity as it does not accurately reflect the risk profile of a number of underlying asset classes.

With regard to simplicity, we welcome the open dialogue that industry has had with the Trading Book Group (TBG) on the calibration of the Sensitivity-Based Approach (SBA) for the standardised approach. While significant progress has been made, there still remain issues with its formulation. In calculating the standardised approach, because sensitivities are broken down by curvature and vega, even slight variations in the calculation can yield very different results. Depending on how the very basic sensitivity measurement is defined, it is possible to have very different results. Also the disaggregation of delta and curvature will materially compromise 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.

We are also of the firm view that internal models must continue to remain a part of the capital framework to guarantee risk sensitivity is achieved. Risk sensitivity is one of the primary drivers of pricing decisions and strategic allocation of resources. It is generally unclear from the FRTB framework, and indeed more broadly in the Basel Committee, that this view is shared in particular given the recent consultation issued on Standardised Capital Floors. Initiatives of this nature are relevant to the risk sensitivity of the overall market risk framework need to be considered in conjunction with the FRTB. In light of this uncertainty, we are uncertain of 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. This is important not only for banks themselves, but also for the clients that banks fund. Without a more holistic view of the interplay of the wider regulatory agenda, there may be adverse impacts on market liquidity and they can fundamentally change the economics of key capital markets products.

Finally, we believe that any regulation should include cost effectiveness among its objectives. The FRTB framework will significantly increase the regulatory reporting burden for institutions, including the regular monitoring of trading activities at the granular desk level and increased disclosure requirements. More generally, extensive system enhancement and increased data processing capacity will be required to calculate and report both IMA and SBA charges. In this case cost of implementation appears to outweigh the marginal risk management benefits.

Outstanding concerns with the FRTB framework

5. Trading and banking book boundary

As stated above, we believe that trading intent should be the primary driver for TB classification with presumptive lists to be used as non-binding guidance only after the ability to demonstrate trading intent has proven insufficient or failed. We believe any deviation from the presumptive should be subject to supervisory notification, as opposed to approval, to avoid over-burdening new product activity.

We would 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.

6. Trading desks

6.1 Trading desk definition

With regards to FRTB desk structure, we are concerned that firms may not have sufficient flexibility to determine their structures in a way that maximizes efficient risk management practice and simultaneously ensures compliance with pre-existing regulatory requirements. Should there be inconsistencies or conflicts between the desk structure imposed by Volcker and the desk structure required by local regulators for FRTB this would be extremely difficult to manage. This will also lead to conflicts when consolidating as it becomes unclear whether a local desk structure or a group desk structure is used. Furthermore, if a local desk falls onto SBA how would this impact the group consolidation?

In addition, as capital is derived from the asset class on a broken down basis, hedges across business lines are not fully recognized. For example, foreign exchange risk arising from equity, credit and rates business lines will generally be internally rebalanced with a foreign exchange desk. However, segregation of asset classes will disincentivise this type of internal hedging and both desks will be penalized.

As stated above, 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 and recommend removing this reference to granularity to increase flexibility and reduce the potential for conflict with structural reform measures.

6.2 Desk level tests

Due to stringent validation constraints the possibility of a given desk falling 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.

6.3 Public disclosure of desk structure

Under the 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 modelling choices
- Disclosure of key differences in models used for internal risk management and those used for regulatory capital calculations

The excess disclosure may be counter-intuitive, highly dependent on how granular the desk level information are 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. We support instead disclosure of FRTB desk structures to national competent authorities/supervisors who are the more appropriate audience for this level of information.

Public disclosure of desk-level information of this nature risks revealing confidential details about a firm's trading strategy that would normally be considered as proprietary information. Revealing this level of data to the market would undermine competitiveness as analysts would seek to derive unfair advantages over competitor firms.

Moreover, this level of disclosure will likely not be well understood by the broader market and may result to increased noise and/or volatility in trading activity. This will especially be the case if a significant number of firms fail back testing requirements, resulting in a move from IMA to SBA without proper understanding of the reason for that failure.

7. Internal models approach: calibration and back testing

7.1 Incremental default risk charge

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.

Additionally, including equity significantly increases the complexity of the calculation. Equity products are often highly-structured and linked to baskets. 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. For a basket constituted by n components, one, two, three and so on simultaneous defaults should be considered representing 2^n combinations. Given this, 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. Also, the consultative paper recommends aligning PD and LGD with the IRB model. At present local regulators may impose floors for these quantities, were the alignment be required then a disconnect will arise between risk management and capital as different recovery assumptions are used. This will also contribute to more divergence in IDRC computation.

7.2 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 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 has since that time has experienced high levels of liquidity.

We would recommend therefore 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 173 c) should be the primary determinants for risk factors to be deemed as ‘modellable.’

Some amendments are needed to the address these new products, specifically for younger 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 HSBC recommends 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, HSBC recommends that on the basis that the long tenors can be proxied, and 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.

8. Standardised Approach

8.1 Calculation of curvature

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.

The curvature charge is not fit for purpose in the case of bounded payoffs (e.g. barriers, digitals, call spreads, etc.) which are misrepresented with a separate delta and curvature capital resulting in total capital greater than max loss possible.

8.2 Treatment of pegged and managed 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%.

8.3 Securitisation

The sensitivity buckets should be more granular to include additional asset classes that Banks trade, for example CLOs. The consequence is a securitization charge that can exceed max loss by many folds.

Disallowing internal model based capital calculation for securitization altogether rather than using a percentage of the standardized charge (e.g. 8%) as a floor makes it all the more important to improve the risk sensitivity of the standardized charge for securitization.