ABI Associazione Bancaria Italiana

ABI response to BCBS Consultative Document

Simplified alternative to the standardised approach to market risk capital requirements

September 2017

POSITION PAPER

1. The Italian Banking Association (ABI) welcomes the opportunity to comment on the Consultative Document "Simplified alternative to the standardised approach to market risk capital requirements".

The Basel Committee acknowledges that the "Sensitivities-based Method" (SbM) - outlined in the new market-risk framework "Minimum capital requirements for market risk" (2016) – may not be proportionate for banks facing less complex risks and may pose implementation challenges for smaller banks. Therefore, a simpler alternative would be more appropriate.

To this end, the Committee has developed a new methodology, that is a simplified version of the SbM – the "Reduced SbM" or "R-SbM". Only banks meeting certain conditions would be allowed to use the simplified approach, depending on the size and complexity of their trading activity.

2. The Basel Committee also encourages comments on whether the R-SbM is fit for purpose and achieves a sufficient level of simplification - or whether retaining the Basel II standardised approach, even if subject to recalibration, would serve as a better alternative.

3. ABI totally agrees on the need for a simple approach for the calculation of market risk capital requirements. In many jurisdictions, banks could result in-scope for the application of capital requirements even though they are not large, internationally active banks.

If compared to the current standardised approach, the R-SbM has merits in terms of risk-sensitiveness. However, the new methodology would imply substantial technical changes and therefore implementation costs. These costs do not appear to be significantly lower than the costs of implementing the "full" SbM[1]. Given the limited risks faced by banks eligible for using the simplified approach - and their minor contribution to the systemic risk – such costs can be considered excessive.

It should also be considered that all banks engaged in trading business will face costs following to the adoption of the new market risk framework, due to the modification of the definition of the trading book.

[1] This is particularly true for banks not dealing options, since the main element of simplification of the R-SbM compared to the SbM is the removal of the vega and curvature risk components.

For these reasons, ABI recommends retaining the Basel II standardised approach as simplified approach. The adoption of a new simplified approach for the calculation of the capital charge would impose an additional burden on smaller banks, that would not be proportionate to the extent of their trading activity.

Indeed, small-medium sized Italian banks with a traditional business model (more focussed on credit to the economy than on trading) usually have very small and simple trading books, also due to constraints in terms of dedicated resources and information availability. For example, the need for sophisticated pricing analysis prevents smaller banks from dealing complex derivative contracts for trading purposes, while lack of information on the composition of funds implies impossibility of look-through and, consequently, higher capital requirements, that discourage this kind of investment.

Switching to a new, more risk-sensitive approach for market risk is therefore of little benefit and definitely not cost-efficient. As a matter of fact, the discontinuation of the current approach would make it impossible to compare market risk figures over time, so banks would lose a widely used tool for analysing the bank's market risk trend.

4. With respect to the envisaged recalibration of the Basel II standardised methodology, ABI agrees that the calibration should be consistent among the different approaches and should not lead to competitive advantages. ABI recommends that such recalibration should be made by rebalancing the capital charge among the different risk classes only if needed and according to the actual risk, bearing in mind the general commitment not to significantly increase the overall level of the capital requirements.

5. We would like to highlight the fact that an impact assessment would be essential to achieve a proper calibration. The assessment should address not only the calibration of the capital requirements, but also the thresholds set in the eligibility criteria (see below paragraph 9). Since the new definition of trading book and the modification in the accounting standards in some jurisdictions may affect the results, ABI suggests that the assessment be performed in 2018, in order for EU banks to be aware of the effects of the application of IFRS9.

6. Whatever the chosen methodology - the Basel II standardised approach or the R-SbM - the criteria for the identification of banks eligible for the use of the simplified approach represent a crucial element of the framework.

7. BCBS standards are generally designed to be applied at consolidated level, while the simplified approach is addressed to a different target. The Basel Committee is aware that, in some jurisdictions, capital requirements are applied not only at consolidated level, but also at legal-entity level. This could give rise to doubts about the level of application of the eligibility criteria.

<u>It is deemed important that the Committee clarifies that the eligibility conditions should be met at the entity level</u>.

Clarification would also be worth having on the approach applicable, at consolidated level, to risks pertaining to subsidiaries using the simplified approach, if the group also includes non eligible banks. It should be clarified that, if consolidated RWAs are determined through a "building block" approach (i.e. assembling RWAs at entity level), RWAs calculated with the simplified approach may be applied at consolidated level (provided that the subsidiary applies it at individual level) even though the parent company or other banks apply more sophisticated approaches.

8. The governance arrangement outlined by the Basel Committee (paragraphs 204-208) appears quite complex, apparently asking for the simultaneous respect of seven conditions and, notwithstanding, for a supervisory approval.

Some observations follow about the proposed conditions.

9. First, the Committee proposes two quantitative thresholds relating to the size of the trading business (paragraph 204, 4th and 5th bullet points): an absolute threshold for the size of the trading book (€ 1 billion) and a relative threshold for the share of the market risk out of the total risk weighted assets of the bank (5%). In ABI's opinion, these thresholds are very low and exclude banks with very simple trading activity. It should also be taken into account that the new definition of trading book, and possibly the adoption of the IFRS9 in some jurisdictions, are likely to boost the size of the trading book compared to present.

<u>ABI therefore recommends that the absolute threshold be no lower than € 5 billion and the relative threshold be no lower than 10%</u>. Clarity about whether the thresholds refer to individual or consolidated figures is necessary: as mentioned before, in ABI's opinion it should be clarified that these thresholds should be met at the entity level.

10. Another eligibility criterion relates to the notional of non-centrally cleared derivatives, booked in either the banking or the trading book (paragraph 204, 6th bullet point). The rationale for the inclusion of such a requirement in this framework is not clear and <u>ABI asks for it to be removed.</u> Incidentally, it is worth noting that, until regulations allow for it (in the EU, EMIR regulations postpone to 2019 the central clearing obligation for financial counterparties with a limited volume of activity, i.e. those classified in "Category 3") smaller banks often rely on bilateral contracts (CSA) while central clearing is less commonly used.

11. According to the BCBS proposal, banks engaged in writing options are not allowed to use the simplified approach (paragraph 204, 2nd bullet point). This condition seems questionable. ABI argues that writing options cannot be considered an indicator of high complexity of the business, since also smaller banks can use simple option strategies involving written options, for example for hedging banking book positions. Indeed, also smaller banks may have written options booked in their trading book, since they could be willing to avoid the burdens inherent to the recognition of those instruments as hedging for accounting purposes (fair value option/hedge accounting) - especially for technically complex hedges, such as for mortgage portfolios, administrative costs and costs for monitoring of the hedged portfolio can be significant. It is worth noting that, while the engagement in the option business could be disliked under the R-SbM (since it neglects vega and curvature risks), such consideration is not valid under the Basel II standardised approach, which also covers non-linear risks - thus making the current approach more suitable. <u>ABI asks for this condition to be deleted</u>.

12. Moreover, the consultative paper (paragraph 205) asks for prior supervisory approval for banks willing to adopt the simplified methodology, even though they fulfil all the prescribed conditions. This would represent an undue compliance cost for both banks and supervisors. <u>ABI recommends that precise and objective eligibility requirements be set and banks meeting those requirements be allowed to apply the simplified approach without the need for prior approval from the supervisor</u>. It seems reasonable that the supervisor be left the power to mandate a bank to apply the SbM in exceptional cases, e.g. when it ascertains that the simplified approach significantly underestimates the overall risk. Supervisory convergence should be fostered in that respect.

13. ABI is aware that the transposition of the standards is not the responsibility of the Basel Committee; nonetheless, the BCBS might demand member jurisdiction to clarify as soon as possible the interaction between the new BCBS standards and local arrangements as to simplified approaches for market risk, if any (in force or in progress). For example, with specific reference to the EU so called "CRR2" proposal, doubts could arise on the possibility of applying a simplified methodology because of the different eligibility criteria.

14. Finally, some observations are worth making on the proposed R-SbM methodology. In ABI's opinion, the proposed bucketing for GIRR is not suitable. Classification in two buckets only seem too simplistic, even if compared with current standardised approach. If increasing the number of buckets is not viable, ABI suggests modifying the threshold, since 5 years is fairly a long time horizon for instruments customarily classified in the trading book. These observations should be read in the light of the fact that the adoption of the R-SbM approach is considered a second-best solution, the continuation of the current standardised approach being the preferred option.