A response by the Latin American Banks Federation – FELABAN to the Basel Committee on Banking Supervision's consultative document on:

Simplified alternative to the standardised approach to market risk capital requirements

---

Dear Basel Committee on Banking Supervision members:

The Latin American Banks Federation (hereinafter *FELABAN*) acknowledges the Basel Committee on Banking Supervision (hereinafter *the Committee)* for the opportunity to discuss the proposals included in the consultative document "*Simplified alternative to the standardized approach to market risk capital requirements*", published on 27th June.

We consider the proposals included in this consultative document, regarding a simplification of market risk capital requirements calculation, are good news for the Latin American banking industry and, furthermore, are in line with the necessity of the regulatory framework to be proportional – this is, for it to be adaptable to the size, complexity and systemic importance of the financial entities. Similarly, we appreciate the Committee's efforts of working in a simplified approach for small and medium-sized banks whose trading activity is low and non-complex, considering the costs and challenges associated the current approach poses for these kind of institutions, as well as its goal of working towards harmonized prudential standards across jurisdictions.

Nevertheless, and after analyzing and discussing its content with the Banking Associations we represent, we kindly submit our comments and concerns to the Committee, which we firmly believe will be a useful feedback to the development of the regulatory and cross-border international framework from the point of view of the Latin American banking sector.

***

Comments on the eligibility criteria for the use of the R-SbM

On the whole, we agree with the qualitative eligibility criteria for the R-SbM use (it cannot be used by G-SIBs or D-SIBs, nor can it be used by entities which currently are using an internal model approach in their trading desks). However, on the other hand, we consider the quantitative eligibility criteria for the R-SbM use should be less restrictive:

- For eligible institutions, the local regulator should have the discretion to define the methodology for measuring Market Risk. This is important to preserve the national segmentation rules - created by the local regulators to separate the banking system among buckets of size, complexity and systemic risk - to better apply the Basel rules and to avoid unintended costs to the smaller institutions.
  To illustrate the latter, Brazilian Central Bank created in February 2017 a segmentation of National Financial System, based on these parameters (complexity, size and risk) for which five segments were defined. The first bucket is composed by the six domestic systemically important banks (D-SIBs) and internationally active level, and the second bucket is composed by seven medium size banks with some systemic relevance. The other three buckets are heavily populated by more than thousand very small financial institutions with assets of less than 1% of national GDP, whose complexity and systemic risk are very low. Therefore, in order to prevent the national segmentation rules and to make regulatory implementation more efficient, the local regulator should be able to define the applicability of the standardized and simplified models.
- The proposed quantitative criteria - market size and exposure to market risk - for eligibility of R-SbM use are rather restrictive and exclude lots of very small institutions other than commercial banks, like brokerage and distribution companies, foreign exchange,

investment banks and trade finance. Almost all of these institutions bring very low systemic risk to the market, but will not be eligible to use the simplified model, being obliged to follow the standardized model proposed. More specifically:

- The proposed limit of 5% of RWA of Market Risk / Total RWA will exclude 43% of 134 Brazilian banks, in addition to hundreds of small financial institutions.
- The quantitative eligibility criteria (sum of assets + liabilities + gross value of the derivatives < EUR 1 billion) will exclude 57% of the 134 Brazilian banks, in addition to a hundred financial institutions of low complexity. It is important to highlight that we didn´t consider in this analysis the gross value of the derivatives, to which we do not have access, therefore more financial institutions may be ineligible.
- In Brazil, there are only five institutions classified as D-SIB, mandatory for full implementation of the Basel rules. These banks account for 70% of system assets. The ten largest institutions represent about 90% of the system's total assets.
- It must be kept in mind that IFRS9 adoption in some jurisdictions (implementation effective from 1st January 2018) may boost the size of the trading book of many financial institutions, which would create the unintended effect of becoming many of them ineligible to use the R-SbM only because of accounting standards.
- Likewise, this quantitative criteria is an <u>absolute</u> number. Consequently, it may discourage organic growth of the entities adopting the R-SbM (to keep being eligible to use it). Moreover, it is subject to exchange rate fluctuations which, in turn, would affect this limit (and therefore capital requirements) even if the underlying risk profile does not change at all. Therefore, it is more reasonable to set up a relative limit (e.g. as a proportion of a relevant indicator) considering this approach seeks to avoid systemic contagion effects should a deterioration in an eligible company's overall fundamentals occur.

It must be kept in mind that a bank’s eligibility to use the R-SbM considers that every single criteria must be met. Therefore, the latter numbers could significantly increase when jointly considering all the requirements. In other words, the criteria seem rather restrictive, and seem not to be aligned with the goal of achieving a simpler treatment for smaller and less complex financial institutions that do not represent systemic risk.

- The eligibility criteria to proceed to R-SbM use regarding the amount of non-cleared derivatives on central counterparty clearing houses (sum of trading book assets and liabilities, as well as market risk weighted assets) should correspond to the measurement of a period of time, instead of a month or a given point in time, in order for the measurement of capital requirements to be homogeneous in a period of, at least, one year. Similarly, it is important to keep in mind that any change on the models to be used require significant efforts and costs for financial institutions and, thus, could not be performed and implemented as quickly as expected.

- Regarding the fact that the use of the R-SbM use is subject to the bank cannot hold any correlation trading positions, How to interpret this condition? Which are the mechanisms to be used in order to verify its compliance?

Comments on the structure of the R-SbM

In addition to these points, we observe the proposed simplification brings an increase in the risk weights for market risk measurement. However, it must be considered that the R-SbM would include only 3 out of the 5 components present on the current approach – SbM. Given this, it is not clear whether the R-SbM will increase the capital requirements for the institutions in relation to the current model. Therefore, we consider as important to calibrate the R-SbM parameters with real data from medium and small-sized banks, so that the final result is not more expensive in terms of capital requirements when compared to the SbM. Should the latter happen, we consider as important to reduce the gap between the parameters used in the standardized approach (SbM) and the proposed one (R-SbM) so that the latter makes sense for small and medium-sized banks to be used (as these institutions are the target group of this consultative document).

The R-SbM differs significantly from the current model, which will demand greater resources (time, money, technology, human resources) from entities which usually do not require high sophistication degrees when it comes to quantify and manage market risk, as these kind of institutions generally do not have a high amount of available resources to proceed with a correct, timely and thorough implementation.

Moreover, in case the R-SbM approach turns out to be more restrictive, its adoption will be expensive from the point of view of capital requirements. Although it will depend on the portfolio under management, it can be observed that low-diversified positions would be associated with higher capital charges under the R-SbM approach when compared to the SbM approach.

In other words, in this case the consultative document would pose financial institutions a trade-off regarding the calculation of market risk capital requirements: either using a complex and demanding approach, which yields lower capital requirements (SbM); or using a simplified approach, which yields higher capital requirements (R-SbM). Under this scenario, none of these alternatives benefits small and medium-sized financial institutions.

In fact, having two separate approaches may lead to industry fragmentation, which in turn may discourage organic growth of small, medium-sized banks and/or banks with more “traditional” business models who decide to adopt the R-SbM approach, as they would have to adopt the SbM approach later - which is more complex. This is even more relevant if there is a significant gap between these approaches, which may impact competition negatively. Thus, we consider as convenient, through reliable data, to determinate the final effect of excluding capital requirements for vega and curvature risks, as well as the effect of applying different granularity degrees on risk factors, correlations and risk weights, respectively.

Aiming to complement the abovementioned, we submit some additional comments with regard to the R-SbM structure. Specifically:

- It is understandable that a residual risk add-on is needed for portfolios with positions involving nonlinear instruments and/or instruments with exotic underlying, according to paragraph 58 of *Minimum capital requirements for market risk* document (January 2016). Keeping in mind that R-SbM’s goal is to simplify market risk capital requirements for low-complexity portfolios characterized by holding linear instruments, we consider market risk capital requirements should not take into consideration a residual risk add-on.
- To compute General Interest Rate Risk (GIRR), the consultative document proposes two buckets (≤ 5 years and > 5 years). However, most markets consider at least three time intervals in their curves (short/medium/long term) which allow to identify several movement across them. Therefore, we suggest to use at least three time interval buckets.
- Within the R-SbM calculation there is no reference or definition about *repo* positions on stocks. Does it mean they will not be taken into consideration on R-SbM calculation?

- Delta GIRR risk weights are more than twice than those of the SbM and, in addition to it, they are identical to each other (5%). Consequently, it implicitly assumes parallel changes over the curve - something that hardly ever occurs under normal market conditions – which strongly penalizes long term operations: not only because of their sensitivity, but also because of the risk weight. In other words, this approach is unnecessarily more restrictive.
- A lower correlation factor (20% vs 40%) might compensate the aforecited, however, this compensation would become effective and suitable as long as the financial institution holds a relatively large portfolio, which may not be the case for those entities for which this simplification is intended.
- The proposed R-SbM includes a 15% surcharge (from 30% to 45%) on foreign exchange risk weights, or in a best case scenario, an 11% surcharge (from 21% to 32%) for the currency pairs specified by the Committee – being USD/MXN and BRL/USD the only ones in our region. This significantly increases the final output in terms of capital requirements, especially when considering this risk category does not include any further relevant modification.
- If financial derivative instruments are to be used, is it still not required to calculate vega and curvature sensibility, keeping in mind the eligibility criteria of being a small bank?
- Stock markets of most Latin American countries are “incipient”, as few financial products are traded in them and whose complexity is generally low. In this sense, market capitalization values defined in paragraphs 239 and 240 place most of Latin American countries on bucket 5, the one with the highest risk weight under the category Equity Risk (which in turn is significantly higher than that of the current approach, SbM). In other words, we consider the proposed sensitivities do not consider cross-border proportionality and imply higher risk market capital requirements to small banks of small countries, for the only fact of operating in countries whose stock markets are in an early development stage.

Market Risk Framework Review

Separately, on behalf of the Latin American banking industry, we would like to point out our concern with the implementation deadlines for the whole process of reviewing the market risk framework of the Trading Portfolio. In the understanding of the industry, as well as for the credit and operational risks, we consider the implementation dates should be postponed to 2022. This kind request is based on the following aspects:

1. The need for significant systemic deployments, either through the implementation of new methodologies, including risk vision and intraday result determination.
2. Modeling of credit factors, which in developing countries require a higher methodological development effort.
3. Use of new methodologies in the management of banks, which requires a maturity that is sufficient to understand the behavior of these new models, as well as the level of capital needed to support it and the time length required to achieve such capital levels.
4. There are some countries ink our region which, due to the abovementioned limitations, are close to the final implementation, or recent final implementation, of the regulatory and supervisory standards included in Basel II, (in fact, some jurisdictions do not require their banking sector to hold capital for market risk management purposes yet).
5. In fact, and despite that the Committee's regulatory standards are the same for every jurisdiction, there are many countries for which transition to Basel III is more complex and more demanding.

On the other hand, it is not possible to know in advance whether this methodological simplification offsets (fully or partially) the proposed higher capital requirements. For this reason, we kindly suggest the Committee to perform a quantitative impact study on this regard, with particular focus on small and medium-sized emerging-markets banks.

Lastly, the Committee acknowledges the R-SbM structure significantly differs from Basel II standard approach, which may pose implementation challenges and costs which tend to be disproportionate with regard to the trading book importance for eligible banks. In this sense, the Committee proposes as an alternative option the possibility of adjusting upwards Basel II standard approach calibration for those banks fulfilling the criteria to use R-SbM. This change would be more convenient and accessible for these banks, considering how familiar they are with this approach - and the fact that the adjustments to be made would be less demanding. Therefore, keeping the current Basel II standard approach for these institutions would be simpler and more straightforward, without posing a significant challenge for these institutions.

Therefore, we suggest the Committee to retain Basel II standardized approach as the Simplified Approach, because adopting and implementing a new standard – as justified previously – would impose higher costs to small banks and, consequently, it might impact negatively its competitiveness.

***

FELABAN wishes to thank the Committee for having considered the above comments, and hope they enrich the development of the market risk approach. Should any clarification arise regarding our comments to this consultative document, we look forward to discussing them further.

Sincerely,

GIORGIO TRETTENERO CASTRO

Secretary General

LATIN AMERICAN BANKS FEDERATION