

17 September 2017

Basel Committee on Banking Supervision

Att.: Basel Committee Secretariat – Bank for International Settlements

CH-40002 Basel, Switzerland

Re: Comment letter on the consultative document – Simplified alternative to the standardised approach to market risk capital requirements, issued June 2017

This comment letter on the above-referenced consultative document is submitted by Dr. Miguel Delfiner. He has been a representative of the Central Bank of Argentina in several Basel Working Groups and Task Forces (e.g. SIG, TFSA, WGOR, TFPMS) and works at present as a short time expert and consultant on regulatory and supervisory issues.

1. Context – The Capital Accord and its implementation in emerging and less developed markets and smaller banks

The main objective of the Basel II framework has been¹ to further strengthening the soundness and stability of the international banking system while maintaining sufficient consistency that capital adequacy regulation will not be a significant source of competitive inequality among internationally active banks. On top of that, the comprehensive set of reform measures known as Basel III² (a giant step forward), were mostly geared towards addressing the market failures revealed by the crisis of 2007-2008. Measures were taken to:

A. Strengthen the global capital framework by:

- i) raising the quality and consistency of capital,
- ii) enhancing risk coverage, on top of the reforms introduced during 2009³, by strengthening the capital requirements for counterparty credit exposures and mitigating the reliance on external ratings.
- iii) Supplementing the risk-based capital requirement with a leverage ratio
- iv) Reducing procyclicality and promoting countercyclical buffers
- v) Addressing systemic risk and interconnectedness

B. Introducing a global liquidity standard (LCR, NSFR and monitoring tools)

Nevertheless, for smaller institutions worldwide, and for most institutions in emerging and less developed countries, implementing the new standards is relatively time-consuming and costly, and on top of that, many of the provisions don't necessarily apply to them. On the other hand, supervisors in many emerging countries not always have the sufficient resources to develop and effectively supervise such a complex framework.

Although the Basel Standards were originally designed with mainly large internationally active banks in mind, in practice most jurisdictions all around the globe strive to comply with them for different reasons (e.g. not lagging as regards the latest regulatory innovations, or complying with International financial sector assessments), insofar creating a heavy burden for some of their low-risk banks and their supervisory agencies.

The relatively higher cost for less sophisticated banks to comply with the same set of rules, leads to a competitive inequality in contradiction with one of the objectives declared by the Basel Framework. This situation is somehow mitigated by offering standardized methods to calculate capital requirements, but again at the cost of a higher capital requirement to compensate for their reduced risk-sensibility. So paradoxically, less risky banks end up with relatively higher compliance costs and higher capital requirements.

¹ International Convergence of Capital Measurement and Capital Standards. A Revised Framework - Comprehensive Version. June (2006), <http://www.bis.org/publ/bcbs128.htm>

² Basel III: international regulatory framework for banks, <http://www.bis.org/bcbs/basel3.htm>

³ These reforms were geared towards raising capital requirements for the trading book and complex securitisation exposures, <http://www.bis.org/publ/bcbs157.htm>, <http://www.bis.org/publ/bcbs158.htm>

As mentioned recently by Mr. Dombret⁴: *“Relief measures for smaller banks, and even separate sets of rules, are not at odds with the aim of a global regulatory regime. The Basel Agreements never set out to establish a single regulatory framework that applies to all banks, without exception, in every corner of the world. In fact, their objective is to make large and internationally active banks more stable by implementing a uniform set of rules and to make sure that there is a level playing field worldwide.”*

These remarks may also be extended for many smaller, medium and even bigger banks in most emerging markets, were banks usually don't show an excessive leverage, don't engage in trading complex instruments, and lack the degree of interconnectedness that caused the international crisis in the first place.

⁴ Speech by Dr. Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the "G20 and Locally Focused Banks" conference, Berlin, 9 March 2017.

2. Market risk features in emerging and less developed markets

To evaluate the applicability and appropriateness of the new Market Risk Standardised Approach to determine capital for banks in most Emerging Markets, it is important to understand the features of these markets and of the Trading Books of banks operating in them.

A – Size of the Trading Book in emerging countries

The intuitive assumption that the Trading Book should be less important in emerging markets than in developed ones, is supported by G-20 members own data:

	RWA Trading / Total RWA ⁵	GDP / Capita ⁶ (USD)
India (06.2015)	6.00%	1,709
Indonesia (12.2016)	0.50%	3,570
South Africa (06.2015)	3.40%	5,273
China (09.2013)	0.80%	8,123
México (03.2015)	24.6%	8,201
Brazil (12.2013)	6.41%	8,649
Russia (03.2016)	4.40%	8,748
Turkey (03.2016)	2.80%	10,787
Argentina (09.2016)	5.28%	12,449
Saudi Arabia (09.2015)	2.70%	20,028
Korea (09.2016)	2.65%	27,538
European Union (12.2014)	6.09%	32,058
Canada (06.2014)	6.30%	42,157
Hong-Kong (03.2015)	4.70%	43,681
Singapore (03.2013)	10.8%	52,960
USA (12.2014)	10.0%	57,466
Switzerland (06.2013)	14.0%	78,812

If we roughly draw the line at a GDP / Capita of USD20,000 the relative importance of the Trading Book may be assessed through the following statistics⁷:

Trading RWA / Total RWA	Developed markets	Emerging markets
Number	7	9
Mean	7,8%	3,6%
Median	6,3%	3,4%
Stand. deviation	3,9%	2,1%

These figures show that the proportion of Trading Book RWA in this sample of emerging markets are approximately half than that of developed ones. Although the

⁵ Extracted from successive BCBS “Regulatory Consistency Assessment Programme (RCAP) - Assessment of Basel III risk-based capital regulations”. RWA stands for Risk Weighted Assets.

⁶ World Bank national accounts data, and OECD National Accounts data files (2016).

⁷ México was left out of the statistics because it's a clear outlier, and Saudi Arabia was assimilated to the emerging market group also its GDP/Capita is roughly over USD20,000.

information is not enough to draw clear conclusions for other emerging countries (let's not speak about other less developed economies), one would tend to think that their Trading Book expositions would follow a similar pattern.

B – Characteristics of the Trading Book exposures in emerging countries

Asides from the relative size of their Trading Book, another important issue are the type of exposures held by banks in emerging and less developed countries, which bears interest to draw conclusions about the riskiness of these items.

Some typical features of emerging markets in Latin-American countries (and probably others) are:

- a. The **F/X component of the Trading Book exposures is usually the most important**, due to the importance of holding foreign currency assets as a hedge against a usually weaker domestic currency.
- b. **Another important holding are usually Government Bonds and Central Bank Securities maintained at fair value**, to earn interest and hold an liquid asset that can be easily converted into cash.
- c. **Derivatives are seldom negotiated**, the bulk involving forwards, futures and swaps on foreign currency and in some cases interest rate forwards and swaps.
- d. **Low liquidity for some instruments** in many emerging markets. In some cases, prices must be inferred from prices of other securities⁸, or in some jurisdictions even provided by a third party called "Price provider".
- e. **Difficulties in building a risk-free yield curve** (let's not speak of a corporate yield curve). OIS and BOR swap curves are mostly non-existent, so only short term central bank instruments and longer term sovereign bonds (although certainly not risk-free) may be available to estimate the curve (r_t). On top of that, the lack of prices or the coexistence of bonds of different nature (e.g. inflation adjusted, amortizing, FRN) or due to the lack of instruments for all maturities of the curve may pose even more difficulties. Usually the short end of the curve can be best fitted.
- f. **Corporate debt**: emerging countries corporate debt in secondary markets of markets lacks liquidity, so trying to figure out a yield curve (or sensitivity for different maturities) for them may become a daunting task.
- g. **Securitisations**: it's unusual for institutions to hold these kinds of securities, except only the few specialized financial institutions that engage in this type of activity.
- h. **Equities are not common** for most institutions and **commodities are practically inexistent**.

⁸ In some countries, due to the lack of market prices, certain agencies called "price providers" generate "reliable" prices for banks to value their holdings in the Trading Book.

3. Simplified alternative to the standardised approach - Comments

We welcome the recognition that “..., the current requirements of the SbM make the revised market risk framework’s standardised approach difficult or not necessarily appropriate to implement and adopt across all BCBS member jurisdictions and non-member jurisdictions.”, because **that is exactly the case for many smaller banks and even jurisdictions.**

To evaluate the applicability and appropriateness of the new Market Risk Standardised Approach to determine capital for banks in most emerging and less developed markets, it is important to consider the issues discussed in the previous two sections and particularly the characteristics of most banks in these markets.

Probably the most straightforward solution to the implementation challenges and costs imposed by the new methodology would be to opt for a recalibrated Basel II standardised approach. This older and less risk sensitive technique has been adopted by many jurisdictions (in some of them even very recently), so keeping it as a fallback option will certainly reduce costs.

But on the other side, choosing this option implies that a very large proportion of banks worldwide, representing a high proportion of banking assets, would be using a significantly different methodology which would be hardly comparable to the new one. The recalibration of the Basel II methodology could even make sense under the actual “Trading Book” landscape, but over time will start losing significance, allowing for regulatory arbitrage opportunities.

So, in conclusion, the best alternative would still be to further work on the R-SbM. But even the R-SbM will be difficult to implement as proposed, given the particularities of jurisdictions other than developed markets or more sophisticated banks.

The proposal that follows intends to simplify the methodology and make it accessible for all banks and supervisors:

- Even before talking about the SbM, **the risk add-on could be eliminated** since by meeting the criteria exposed in p.204 it will be irrelevant.
- **Do not include** as a requirement (p.204) **a restriction on the ratio Trading RWA / Total RWA (e.g. 5%)**, because as shown in section 2, some jurisdictions have in average a ratio bigger than that, but for reasons that not necessarily imply sophistication in their trading activities (e.g. F/X exposure, government bond held securities).
- Don’t over-compensate the lack of sensibility by increased risk weights (RW), at least not in such a degree as proposed. **RW for GIRR have increased from 1.5% to 5% for 5% (more than 3x) and in the short end of the curve practically doubled.** A similar situation arises for CSR RW. As mentioned in section 1, this leads to a higher cost for less sophisticated banks and an unequal level playing field in contradiction with one of the landmarks of the Basel Framework.

As specifically regards the R-SbM there is still a need to significantly simplify it:

- Under the condition that only one foreign currency is the most relevant (that is the case for most less sophisticated non-internationally active banks), **allow to collapse all holdings of foreign currency into the most significant one**. This meaning that the risk buckets for GIRR will only be two.
- **Eliminate paragraphs 212., 213., 223. and 224.** referred to inflation and cross-currency risks.
- **Simplify the calculations, by including in the step-by step approach with all necessary elements.** In the ideal case sections 3 and 4 could be erased completely (there's no need even to talk about correlations and risk factors) not forcing the reader to jump from one section to the other. **E.g. for GIRR** (only two currencies domestic and F/X and without inflation and cross-currency risks):

Step 1:

$$WS_{\$,i} = 0,5 \cdot S_{\$,i} = 0,5 \cdot \left[\frac{V_i(r_t^{\$} + 0,0001) - V_i(r_t^{\$})}{0,0001} \right]$$

$$WS_{FX,i} = 0,5 \cdot S_{FX,i} = 0,5 \cdot \left[\frac{V_i(r_t^{FX} + 0,0001) - V_i(r_t^{FX})}{0,0001} \right]$$

Step 2:

$$K_{\$} = \sqrt{\sum_i WS_{\$,i}^2 + 0,2 \cdot \sum_i \sum_{i \neq j} WS_{\$,i} \cdot WS_{\$,j}}$$

$$K_{FX} = \sqrt{\sum_i WS_{FX,i}^2 + 0,2 \cdot \sum_i \sum_{i \neq j} WS_{FX,i} \cdot WS_{FX,j}}$$

Step 3:

$$S_{\$} = \sum_i WS_{\$,i} \quad \text{and} \quad S_{FX} = \sum_i WS_{FX,i} \quad \text{then:}$$

$$\text{Delta GIRR} = \sqrt{|K_{\$}^2 + K_{FX}^2 + 0,5 \cdot (2 \cdot S_{\$} S_{FX})|}$$

- **Delta CSR:** Given the difficulties in building a yield curve for corporates and securitization products using market data in most emerging and less developed markets, propose a standardised way to find the r_t using the risk-free curve (e.g. by adding a fixed spread to all points). In the case, were these products represent a very small proportion of interest rate sensible products (e.g. less than 10%), even **consider a simple way of calculating CSR, e.g. as a fixed proportion of the Delta GIRR**.
- **Delta Commodities: consider elimination.**
- **Delta Foreign exchange risk:** given the importance of foreign exchange risk in emerging and less developed markets **an increase from 30% to 45% is inappropriate**, attempting against creating a level playground. Even more so, since the exposure taken in those markets are mostly for hedging instead of trading purposes.

The changes proposed in this section may seem too radical or at least to over-simplify the methodology, but given the proportion of trading book RWA in banks allowed to use it, the impact in terms of capital shouldn't be that high. The reduction in relative costs for small banks and its comparability with the new standardised method more than compensate for this shortcoming.