

Nomura International plc

1 Angel Lane, London EC4R 3AB
Tel +44 (0)20 7102 1000 Fax +44 (0)20 7102 9090

Derek Nesbitt
Chair, Market Risk Group
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND

19 June 2018

RE: Consultative Document, Revisions to the minimum capital requirements for market risk

Dear Mr Nesbitt,

Nomura would like to thank you for the invitation to comment on the document Revisions to the Minimum Capital Requirements for Market Risk, published on 22 March 2018.

We would like to take this opportunity to welcome the bulk of the revisions proposed to the market risk capital requirements, and in particular:

- The changes to the standardised approach, which result in a more risk sensitive calculation, while still preserving the features of simplicity and comparability required in a standardised method. There are however some pockets of uneconomic behaviour which remain, for example the capital charge to the Correlation Trading portfolio, and we would like to express our support for the proposals made by ISDA/IIF/GFMA on this topic.
- The revisions to the requirements around the P&L Attribution test, which incentivise good risk management practices and make passing the test an achievable goal, yet still require significant enhancements by firms in their risk modelling capabilities and systems to qualify for internal models under FRTB.

We do however wish to express our continuing strong concerns around the Non-Modellable Risk Factor (NMRF) rules, which in our view have not been addressed in the latest consultation paper.

Analysis done by Nomura indicates that the 'real price requirement' to establish modellability will render a significant proportion (around **50%**) of existing risk factors non-modellable. When such risk factors are forced into the NMRF capital calculation, which generally does not reflect netting or diversification with any other risk factors, the resulting capital charge can be both very large and highly volatile. Market intelligence suggests that this impact is observed by other firms, although the impacts can vary widely as firms apply different assumptions around which risk factors are (and will be) shown to be modellable.

We understand that the committee wishes to incorporate risk factor liquidity into the model eligibility framework, but in our view the "real price" requirement as currently specified is not an appropriate way of doing this. Even where a specific firm has not executed a new trade for some time, liquidity can be checked in a range of other ways, such as:

- Market quotes from established data providers such as Bloomberg, MarkIT and Reuters;
- Price reconciliation as part of collateral exchange on OTC derivatives.

All of these are well established market conventions for establishing market prices, widely used by firms and regulators alike. We do not think they should be dismissed as valid indicators of market depth for the purposes of model eligibility.

We welcome the recognition of data vendors as a possible source of real price data, but caution that the effectiveness of this solution has not yet been established. Even if vendors do demonstrate that they can establish an auditable process for this, it will create a high degree of reliance on third party data in firms' capital calculation process.

We also have a concern about the adverse effects of the NMRF rule on market liquidity. The requirement could lead to a 'spiral of illiquidity', such that if a particular risk factor becomes slightly less frequently traded and hence is classed as 'non-modellable', this will generate a large increase in capital requirements and consequently reduce firms' appetite for this risk, causing a further reduction in liquidity. This effect could become a source of instability and pro-cyclicality in capital requirements. A similar issue arises around IPOs and other 'new' risk factors, e.g. an emerging market government issuing debt in the capital markets for the first time. By construction, real price data on such risk factors will not be available to firms until they begin trading, and hence they will automatically be rendered non-modellable for the first year of their existence, regardless of how actively they are traded after issuance. The highly conservative capital required to such new risk factors could naturally lead to less appetite for them from banks, and an associated increase in hedging costs for end-users.

For the reasons outlined above we believe that a holistic review of the proposed NMRF framework is warranted, and would like to put forward the following recommendations for this. In each case, the proposed change would require only a minor amendment to the FRTB text, but would go a long way towards mitigating the potentially adverse impact of NMRF:

- 1) Include a calibration factor in the rule, which can be modified as and when more robust data on NMRF capital impacts are available. One way to do this is to introduce a correlation coefficient to be applied to all asset classes in the NMRF calculation, i.e.

$$SES = \sqrt{\sum_{i=1}^I ISES_{NM,i}^2 + \sum_{j=1}^J ISES_{NM,j}^2 + \sqrt{(\rho * \sum SES's \text{ of all other NMRFs})^2 + (1 - \rho^2) * \sum (SES's \text{ of all other NMRFs})^2}},$$

where the first two terms above refer to NMRF arising from idiosyncratic credit spread and equity risk respectively. The value of ρ could be calibrated as and when the Committee has had time to fully assess the capital impact of the NMRF framework, including the potential impact of vendor data.

- 2) Permit a wider source of data to establish modellability, for example by allowing collateral exchange as evidence of modellability. This would reduce reliance on third party vendors and avoid the 'spiral of illiquidity' described above. We see collateral exchange as particularly suitable for this as it is an economically substantive process which is already embedded in regulation, and so could robustly and reliably be extended to demonstrate modellability. While exchange of collateral does not in itself prove a market to be tradeable, it does show a risk factor to be sufficiently well established that two firms with opposing economic interests can agree on its value, to a given tolerance level. Moreover, potential deviations from the reconciled value due to illiquidity are already capitalized via the IMA Liquid Horizons.
- 3) Modify the most punitive features of the NMRF framework, specifically the use of 'max gap' in establishing modellability and in setting the liquidity horizon for capitalising NMRF. A simple and intuitive replacement is to use the 'mean gap' rather than 'max gap' in both cases, i.e.
 - o Define a risk factor to be non-modellable if the mean gap between consecutive observations of real prices is greater than 10 business days, and
 - o Set the liquidity horizon for a NMRF as max(IMA LH, mean gap)

Beyond mitigating the size and volatility of the capital associated with NMRF, such a change would naturally enable new, liquid risk factors to quickly qualify as modellable, despite the large 'gap' in observability in the period before they were first traded.

We hope that the committee will find our proposals valuable and look forward to further constructive engagement on finalising the FRTB framework.

Yours sincerely,

Eduardo Epperlein

Head of Risk Methodology, Nomura