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Basel Committee for Banking Supervision
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Sent via: http://www.bis.org/bcbs/commentupload.htm

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Response to the BCBS simplified alternative to the standardised approach to market risk capital requirements (BCBS-408) by Parker Fitzgerald

Dear Sir or Madam,

1. Introduction

We would firstly like to introduce ourselves, as we have not previously responded to a consultation from the Basel Committee for Banking Supervision (BCBS). Parker Fitzgerald (PFG) is a specialist management consultancy focused within the finance sector. The firm provides strategic advice, assurance and consulting services in all areas of risk management, regulation and financial technology.

On 29 June, the BCBS issued a consultatative document[1] that proposed a simplified alternative to the standardised approach to market risk capital requirements, known as the Reduced Sensititivities based Method (R-SbM). PFG is pleased to have the opportunity to respond to the BCBS's consultation on these proposed regulations.

2. Summary of Main Points

In summary, we are generally supportive of the efforts of the Basel Committee to ensure that the regulations put in place are not overly complex for banks with low materiality of trading book risk. However, we have two points to raise in response, which we summarise below and explain further in Section 3:

1. The main question raised by the Committee is whether to allow small banks to use the existing (Basel-II) regulations or for all banks to adopt the new risk sensitive regulatory structure. We consider that any organization that creates trading book risks as part of its business should be expected to manage those risks in a more risk-sensitive way, as we explain in Section 3a. As such, we do not think it is appropriate to maintain the current regime for a subset of market participants.

2. Paragraph 204 of the proposal suggests the use of Notional as a metric to determine whether a bank can qualify for the R-SbM. We appreciate that Notional scales with risk for linear exposures, but we do not consider Notional relevant for determining whether the R-SbM can be applied. We consider that using Notional could interfere with hedging practices and banks can circumvent this restriction by using more complex or leveraged products (e.g. options), which we explain in Section 3b.

3. Exposition of Main Points

3a. Choice of R-SbM or Existing Rules for Qualifying Banks
The primary question raised by the Basel Committee is whether to:

A. Only have the new IMA and SbM approaches

[1] http://www.bis.org/bcbs/publ/d408.pdf

B. To have a Reduced-SbM approach for smaller banks in addition to the new IMA and SbM approaches for larger banks
C. To allow smaller banks to keep a recalibrated version of the Basel-II rules but to implement the new IMA and SbM approaches for larger banks.

	Banks below threshold	Banks above threshold
A	IMA/SbM	
B	Reduced-SbM	IMA/SbM
C	Recalibrated Basel II	IMA/SbM

With regards to Approach A, we consider that this would be favourable in an “ideal world”. However, we appreciate that the costs may outweigh the benefits for small banks where the trading book risk has low materiality compared to the banking book risk.

With regards to introducing a less burdensome approach, we consider that there are three criteria that favour Approach B to Approach C:

1. *Encouraging future competition*: if banks either side of the threshold (between qualifying and not qualifying for the simpler rules) have different regimes, then there is a hurdle to cross if smaller banks wanted to expand their trading books beyond the threshold. This hurdle comprises the cost of new infrastructure, the effort of introducing new risk management processes and the ongoing effort of producing and validating the calculation inputs and outputs.

    a. The hurdle is greater if the current Basel II rules are kept for the smaller banks. Smaller banks looking to expand would need to both migrate their infrastructure to the new capital calculations and migrate to managing capital under the full SbM regime. Such banks may choose not to expand, or to restrict services, rather than adopt the full SbM rules.

    b. On the other hand, if such banks were to migrate from R-SbM to SbM, the hurdle for implementing the new infrastructure would be less and so would be the difference in understanding the change in the capital requirements.

2. *Ensuring risk sensitivity in capital calculations*: it is a general principle that any firm that creates risk should manage that risk correctly. Many smaller banks do not have sophisticated market risk management procedures as their trading books contribute a small part of their overall risk. For such banks, regulatory compliance is often used as a proxy for trading book risk management. It is sensible for the capital that is required to be held against those risks to be based on the riskiness of the positions that the bank trades.

3. *Prevention of regulatory arbitrage*: where the rules on both sides of the threshold are calculated using entirely different approaches, this leads to the potential for the smaller banks to have lower capital charges on the same portfolio than they would under the SbM. The R-SbM reduces this risk by requiring higher calibrations for the same risk exposures.

3b. Use of Notional as a Metric
Paragraph 204 of the proposal includes the following text: “[The aggregate notional amount of non-centrally cleared derivatives (including both banking book and trading book positions) must not exceed [€X billion].]”

Outstanding Notional is a scalar amount that increases with each new transaction. This means that a Notional limit may serve to encumber hedging using non-centrally cleared derivatives (e.g. forward contracts in markets without CCPs), which would hamper the banks from managing their risk.

Notional is also not relevant as the banks are still permitted to use options under the R-SbM. There is a risk that, if the banks have a Notional limit, they would be tempted to use more complex or leveraged products (e.g. cliquet options) to stay within the Notional limit as they approach the threshold. This would be a perverse incentive and contradictory to the presumed regulatory goal as this would increase risk (market and operational) for less sophisticated treasury operations.

4. Minor Points/Questions

We also had questions on three points that we noted in the table below.

Paragraph	Relevant text	Question
240	Canada, the United States, Mexico, the euro area, the non-euro area western European countries (the United Kingdom, Norway, Sweden, Denmark and Switzerland), Japan, Oceania (Australia and New Zealand), Singapore and Hong Kong SAR.	This list excludes, for example, Iceland and S Korea. Although this list is consistent with para. 105 of the main Minimum capital requirements for Market Risk document[2], what criteria are used for the inclusion/exclusion on this list?
247	Precious metals (including gold) 30%	Should the rules allow the optional treatment of precious metals (in particular XAU, XAG) as FX rather than commodities? We envision that the majority of small banks will have trading books dominated by interest rate and FX positions. Including precious metals as FX risk would mean that banks do not need to also implement the commodities rules to manage small gold positions.
251	A unique relative risk weight of 45% applies to all the FX net sensitivities	1. Should there also be different correlations between the specified and unspecified pairs? 2. Will onshore and offshore currencies be treated as the same or different currency pairs?

5. Conclusion

Both approaches (the current and the Reduced SbM) have pros and cons. In deciding on which approach to adopt, the Committee should look towards regulations that are more risk sensitive and that also allow a smoother transition to more sophisticated approaches if the size of a bank's trading book were to increase.

We believe that in addition to being more risk sensitive the Reduced SbM would also promote a cost-efficient upgrade to the underlying risk management infrastructure. Hence, **we endorse the Committee's proposals** to allow smaller banks to apply the Reduced SbM.

We would like to thank the Committee for the opportunity to respond. Please contact Dr. Nasir M. Ahmad (nahmad@pfg.uk.com) and Dr. Philip Symes (psymes@pfg.uk.com) if you have questions or comments on our response.

Yours faithfully,

Parker Fitzgerald

[2] http://www.bis.org/bcbs/publ/d352.htm