



20 February 2015

Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Consultative document – Fundamental review of the trading book: outstanding issues

Dear Sir/Madam

We wish to submit feedback in respect to the recent consultative document: 'Fundamental review of the trading book: outstanding issues'.

SunGard Financial Systems provides leading software and IT services to institutions in virtually every segment of the financial services industry. Its solutions support both standard calculations and internal model approaches (IMA) with many banks having IMA approval around the world. SunGard therefore has significant experience in the development and operational delivery of the outcomes needed to support these regulatory calculations.

Specific Question Feedback

Q1. What are your views on the specific refinements described in the three sections of this consultative document?

Given the level of detailed required, comments in respect to the specific refinements presented in the consultative document have been provided in Appendix A.

Q2. Do these specific proposals strike the right balance between simplicity, comparability and risk sensitivity?

As for Q1, comments on striking the right balance between simplicity, comparability and risk sensitivity are included, where appropriate, in the Appendix.

We hope you will find our comments useful in future revisions of the proposed trading book capital framework.

Yours faithfully,

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Appendix A: Specific Comments on December 2014 consultative document refinements

Note: all page numbers referred to below, relate to the December 2014 Consultative Document

Internal risk transfers

BCBS has provided two possible approaches to the transfer of general interest rate risk (GIRR) – ‘Option 1’ and ‘Option 2’ on page 5.

SunGard would suggest that the repeated use of the word ‘exact’ within the text in Box 1 will, in effect, make it prohibitively difficult for banks to comply with the internal risk transfer requirement; which in turn is likely to result in manageable wholesale-equivalent risk being left in the banking book. On an overall entity basis, this could unnecessarily increase the organisation’s risk profile – even though much of the risk could be materially hedged.

Of the two options provided, ‘Option 2’ is preferable. However SunGard would recommend that BCBS consider:

- Explicitly recognising that GIRR within the banking book may be quite similar to liquid wholesale market instruments but acknowledge that they may not have exactly mirrored risk profiles.
- Allowing for a degree of non-exact hedging: as long as it is clearly identified; properly justified; measured and monitored. BCBS could also possibly require stress testing of the risk versus the hedge, to better understand possible stressful market valuation behaviours, i.e. retail vs. wholesale basis risk.
- Providing hedge effectiveness principles to support consistent local regulator supervision of non-exact hedging which could further align finance and risk management.

It is also unclear why the same general framework and supervisory requirements could not also be used for credit and equity risk transfers – rather than having a separate approach for GIRR.

Revised standardised approach for market risk

Whilst recognising that a sensitivity based approach is likely to be operationally simpler than internal modelling of market risk capital for banks with modest trading operations, it is suggested that the final document include guidance in respect of controls which should be associated with sensitivities being employed, as these sensitivities often originate from front office systems which are operationally controlled by the trading business.

It is suggested that regulators should have a clear preference for sensitivity based outcomes generated from systems or processes which are truly independent of the trading business. For example, does BCBS envisage that all pricing and valuation relevant data is defined and monitored by a function independent of front office? BCBS could usefully provide guidance to local regulators around the size/complexity of trading books where data independence should become mandatory.¹

Given the range of factors, definitional assumptions and calculation weight inputs which are reasonably needed to support the proposed framework, it is recommended that BCBS should predefine a routine cycle for their review/update – perhaps bi-annually – together with a process by

¹ Where SunGard provides both trading and risk solutions to its clients, the valuation calculations employed can be different model libraries / code bases as required.

which, it might make more urgent changes. This would allow all stakeholders to these processes to be able to plan upgrade and refresh cycles into their forward business activity plans.

Basis risk

The heightened focus on basis risk is prudent given experiences over the past few years. Of the two approaches discussed, it is suggested that the correlation method is more intuitively aligned with actual market behaviour – recognising the issues which BCBS highlights on page 8.

SunGard acknowledges the Committee's desire to provide a framework which balances being relatively simple with seeking to represent the risk effectively: however the tables on page 28 imply that interest rate correlations will be the same for all currencies and interest rate products. It is believed, that this may be a too significant simplification.

It is suggested that the tables on page 28 act as a most favourable outcome and that additional currency-specific correlations be specified to more accurately reflect individual currency-centric behaviours.

Presumably – based on the outcomes being sought – the correlations which have been defined on page 28 reflect stressful market outcomes.

Vega risk

It is not clear that under stressful market conditions – for which capital is ultimately being held – that all forms of vega sensitivity should be assumed to be a 'linear risk' as stated on page 12.

However, it is recognised that, for trading desks with modest 'vanilla' option positions the valuation impacts could be linear. The proposed standard approach (formulae on page 22) is therefore a reasonable approach for these types of trading desk.

However, it is recommended that BCBS also

- provide clear guidance in respect of the scale of vega risk which a bank can be exposed to, before internal modelling of the risk became a strong regulatory requirement; and
- specifically exclude exotic, or path / time window based option instruments which are unlikely to have linear valuation outcomes – relative to the shocks applied – and for which vega sensitivity alone is probably not a robust measure of the true risk exposure.

It is also suggested that the level of granularity reflected in the 'Risk factor category' table in Section 2.4.1 on page 12, is unlikely to be suitable for production operations. However, the text of this section implies that in the future, the base liquidity horizon used to calculate the relative risk weight will be linked to the broader table of liquidity horizons (currently documented on page 20) which would be more internally consistent.

Risk of market illiquidity / 'liquidity horizons'

The introduction of a spectrum of 'liquidity horizons' to mimic possible market behaviour is very reasonable. However, the current approach has a number of structural short-comings:

1. Being based on a fixed horizon concept, it makes no allowance for the scale of exposure that an organisation may need to neutralise in stressful market conditions, versus the expected market turnover in the same conditions. This is likely to have the effect of penalising banks with modest trading positions used mainly for hedging purpose versus organisations with very material trading activities.

2. Whilst some degree of correlation is recognised, it appears that the approach will generate a very conservative outcome for organisation with positions across a number of asset classes, i.e. minimal recognition of portfolio effects.

Whilst recognising that a major change in approach is now unlikely, it is suggested that a turnover-driven liquidity horizon would be more realistic and not create material increase to the level of complexity that will be required to implement the overall calculation process.

Expected shortfall

It is our experience that most benefit can be achieved by the change from Value at Risk (VaR) to Expected Shortfall (ES) when calculating ES using a full revaluation approach.

We note that the 'Quantitative Standards' (on page 19-20) have included additional risk factor categories which is a welcomed development.

However, many risk practitioners will find some of the proposed outcomes to be relatively counter-intuitive: for example, that the 'n' for 'Credit Spread – sovereign (IG)' is 20, which is the same as that being proposed for 'Equity price (small cap)'. In many markets, there would be a perception that high quality sovereign debt (often used to help manage bank liquidity) would remain much more liquid than small cap equity stocks and should therefore be associated with a shorter liquidity horizon.

It is also suggested, that there be a routine – at least annual - update process associated with the definition of 'FX rate – liquid currency pairs' as these could change in a relatively short period of time; for example, the USD/RUB may not currently be a liquid currency pair in wholesale markets.

In respect to Footnote 2 on page 20: one issue that BCBS has not overtly addressed is the correctness of historical data sets. Given that the ES process is specifically focusing on tail outcomes, its accuracy will be quite sensitive to the absence of true valuation input outliers (more so, than the current HS-VaR calculations); for example, where historical rate validation processes may have incorrectly adjusted input outliers, i.e. smooth the outcome. Downstream users would not automatically notice the absence of the mis-corrected outlier, as it may not have driven material valuation change and by its absence did not drive a VaR outcome to be investigated.

To increase assurance that observation histories correctly reflect all material outliers, two approaches could be adopted:

1. All major (obtainable) rate histories could be reloaded from the unadjusted original source and re-validated: this would obviously be a significant effort but could be justified if it were believed that a bank's input validation processes may have artificially reduced true outliers; or be focused on asset classes with the most material positions.
2. Require banks to provide detailed ES outcomes based on a comprehensive test trade portfolio. Whilst this could, in part, have occurred as part of the QIS process undertaken – it may need to be undertaken in a broader and more detailed manner; and outputs provided in a format which allows regulators to readily identify institutions which are reporting particularly high or low outcomes for each test transaction.

The proposed methodology should also specifically identify the approaches to be used where the observed price movement may not be a good metric of risk in a stressful environment, particularly for currencies where the FX rate is controlled against a peg/basket mechanism, or where there are currency conversion volume limitations, which could trigger material price shocks when a market event occurs (which might not be in the observation window).

Definition of risk factors

GIRR

On page 23, the proposed standard approach requires that GIRR delta factors be defined relative to a risk free curve for each currency, across ten remaining maturity term points.

The current document does not appear to address the significant issue of how 'risk free' curves for every currency can be derived (except for noting that market rates should be used rather than 'zero coupon' rates). If some degree of residual sovereign risk is ignored, 'risk free' curves can be relatively easily constructed for many currencies, i.e. where there is an active market in AAA rated debt instruments. However, there will also be a significant number of cases where the sovereign government associated with a currency is not AAA rated, nor is there a sufficient market of AAA rated multilateral development bank debt from which to imply a 'risk free' curve for the currency.

It is therefore suggested, that BCBS should identify a preferred approach to be employed when sufficient AAA inputs are not available (across the entire observation window), to reliably construct a 'risk free' curve. It is possible that, given the range of situations to be addressed, a waterfall of preferred approaches could be needed.

Alternatively, the GIRR sensitivities could be defined based on a 'least-risky' observable base curve for that currency; and BCBS could supply pre-defined add-ons to proxy a risk free-curve based outcome.

However, it is noted on page 39 that national discretion allowance is made for zero default risk for certain 'sovereigns, public sector entities and multilateral development banks'. Therefore it is likely that the treatment of non-AAA currencies needs to tie back into the overall framework treatment, i.e. if banks are not required to hold default risk capital against these non-'risk free' entities, does this imply that their debt issuances should then form the basis for GIRR sensitive calculations?

If so, then the terminology used within the framework probably needs to be amended, from 'risk free' to 'least risky'. However it would still then need to address the situation, when there is an observable AAA multilateral development bank(s) curve; and also a non-AAA sovereign curve.

CSR securitisation

The proposed sensitivity approach is driven by 'issuer/tranche credit spread' but in a range of cases the securitised instrument has little connection with the issuer's rating.

It is suggested that specific guidance be provided for simple securitised instruments, which typically have a single tranche and single, relatively homogenous underlying constituent asset pool, i.e. residential mortgages, credit card or car lease receivables – otherwise these instruments, which are important funding tools for some market participants would be difficult and costly to support.

It is also noted that on page 26, the definition of a 'correlation trading portfolio' is very specific and, in practice, is likely to exclude a number of portfolios which are materially used for 'correlation trading'. The very specific tests employed suggests that BCBS should also define transition arrangements to address situations where a portfolio moves into, or out of, the 'correlation trading' definition.

Equity risk factors

BCBS should provide guidance in respect to the treatment of expected versus unexpected price movements; for example, dividend forecasts are (correctly) a risk factor but it is unclear whether the calculation process should adjust the observable spot price to the extent that an announced dividend payment impacts it, i.e. on the ex-dividend date.

It is also suggested that BCBS clarify that 'equity risk factors' only relate to traditional single company shareholder equity holdings and are not to be used for the significant range of other types of value ownership which can now be traded via traditional stock exchanges (including Listed Investment Companies, Exchange Traded Funds etc.).

To address these types of listed instruments, it is likely that a general risk pass through principle should be employed: where banks will need to clearly identify the underlying risk factors of these stocks, i.e. map them to different risk factor classes: interest rates, commodities, FX or devolve them into underlying constituents (if understood).

Default risk

Non-securitisations

It is suggested that further explanation be provided in respect to the 'Examples of components in the JTD² equation' on page 41; as the Bond 'MtM loss' metric is non-intuitive. In trading books, bonds would typically be carried at their market value. Therefore, in a JTD situation, the maximum accounting loss incurred would just be the market value (not 'face value – market value').

It is suggested that further clarification is needed in the JTD calculation process – including whether there should be any differentiation in loss given default for senior secured debt.

The approach presented for offsets to the same obligor (page 42) has different treatments triggered on remaining maturity versus a capital horizon (one year) – which conceptually, appears to be inconsistent with the liquidity horizons defined on page 20.

If, for trading book capital calculation purposes, BCBS deems that banks could be exposed to the obligor for between 20 and 250 days, it would be more internally consistent to base the JTD capital requirements – including the default risk weights – on the same liquidity horizons rather than fixed a 1 year default horizon viewpoint.

BCBS should also clarify the treatment to be employed for instruments such as covered bonds – where an owner of the instrument has recourse against both the issuer and a specifically defined pool of assets.

Securitisations

It is recommended that specific JTD capital calculations be defined for simple securitisation products – which by the nature of their underlying asset pool, are very unlikely to JTD – in these cases if required at all, the JTD equivalent capital charge should be driven by other factors.

² Jump to Default