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Basel Committee
on Banking Supervision**Fundamental review of the trading book: outstanding issues - consultative document**

We support the Basel Committee's objectives in revising the market risk framework. We welcome the clarifications that have been given as part of the quantitative impact study process in 2014 and in the present consultative document. We also appreciate that the Committee has given consideration to many of the concerns expressed by industry in response to the second consultative document.

General comments

The Committee has of yet not communicated its intended calibration of the revised framework. In our view, on an aggregate industry level, capital levels should be unchanged from the current market risk framework. Basel 2.5 was developed as a response to concerns about too low market risk capital levels and further adjustments on an aggregate level should not be needed.

To ensure that banks maintain risk sensitivity in their currently high standards for measurement of market risks, we believe it is important that the future framework creates incentives for banks to implement and to apply for permission to use the revised internal models approach for market risk. In this respect, it is also vital to consider the interplay between the market risk framework and the design and calibration of the revised capital floor that the Committee proposed in December 2014.

Furthermore, we are concerned about the lack of discussion of the implementation timetable for the revised framework. We would like to stress the importance of having a sufficiently long implementation period considering the magnitude of the proposed revisions. The revised standardized approach represents a complete overhaul of the current standardized approach and the new internal models approach incorporates far-reaching changes. For banks to properly implement and validate the new approaches without creating significant operational risks, considerable time is needed.

As the Fundamental review of the trading book contains several new measures and

risk models we would like to stress the need for more quantitative impact studies ("QIS") in order to make sure that the models and calibrations are satisfactory to work the way intended. Due to the short time period between the release of the third consultative paper ("CP3") and the 2015 Q1 QIS, banks will find it challenging to implement all the new and added features in the CP3.

Internal risk transfers between the banking book and the trading book

In the consultative document, the Committee puts forward proposals for a treatment for internal risk transfers (IRTs) with the aim of balancing the need for effective risk management against concerns that IRTs could compromise the banking book/trading book boundary.

We do recognize the need to constrain IRTs to avoid creating incentives for capital arbitrage. However, we believe that the presented proposals do not strike the right balance between effective risk management needs and concerns for regulatory arbitrage.

In particular, for the treatment of IRTs for general interest rate risk (GIRR), the Committee consults on two alternatives. According to the first alternative (option 1), the external hedging instrument must exactly match the IRT. In the second alternative (option 2), IRTs can be treated on a portfolio basis, but must be separated from the rest of the trading book.

Both alternatives leave room for interpretations. Therefore it would be beneficial if both options were clarified through numerical examples showing for the IRT, the external hedge and the underlying position exactly how the inclusion / exclusion of the IRT and external hedge affects trading book and banking book capital requirements distributed over requirements for market risk, CVA risk, counterparty risk and credit risk.

We are however hesitant to both alternatives. Both proposals imply that, in the context of hedging risks in the banking book, the trading book can only be used a pass-through device. If a bank has the intention to hedge GIRR in its banking book, the bank must, on an aggregate level, hedge the risk using external counterparties, even in the case where the bank has an opposing risk in its trading book that it could have netted its risk in the banking book against.

That implies that the risk would be transferred to an external counterparty instead of netting the risk against another risk within the bank. Counterparty risk in the financial system would increase, or put differently, the bank would be forced to increase its interconnectedness with the rest of the financial system by entering into more derivatives contracts with external counterparties. That, in turn, would increase systemic risk in the financial system.

Moreover, even though the objective of the proposed treatment is to prevent banks from reducing their capital requirements by shifting risk between the banking book and the trading book, the proposal does not prevent a bank from transferring risk from its banking book to another bank's trading book. On an aggregate level, banks would thus still have incentives to transfer their risks to the book where it would receive the most preferential capital treatment, even though that book might reside in another bank.

The proposed treatment could also create an incentive for banks to enter into two offsetting contracts with an external counterparty. The first contract would be between the bank's banking book and the external counterparty. The other contract would be between the bank's trading book and the external counterparty. That would effectively mirror the risk back into the bank, thus circumventing the rule.

Under the current market risk framework, the part of a bank operating the banking book could regard the trading operations of the same bank as a counterparty similar to any external counterparty. When the part of the bank operating the banking book has a hedging need, it could choose the counterparty that offers the best price for the hedging instrument, including the trading operations of the same bank. However under the proposal put forward, the part of the bank operating the banking book would effectively lose one counterparty. That risks causing increased concentration in the derivatives market, deterioration in the liquidity and increased cost of hedging.

In a small and concentrated derivatives market, such as the Swedish market, the aforementioned problems would be exaggerated. In such a market, the hedging needs of banks are large relative to the size of the market. Concentration would increase even more and hedging costs would rise.

Another potential consequence is if banks' trading operations cannot hedge any risks using internal risk transfers, their costs for hedging might increase. That could, in turn, make banks' derivative contracts towards clients being priced more expensively. Clients might then choose to hedge less of their risks, which would intensify risks in the financial system.

Due to the aforementioned reasons, we would prefer a solution which would allow genuine internal hedges while still not compromising the boundary between the banking book and the trading book. If banks would be allowed to net risks internally, the interconnectedness in the financial system would decrease, which would lower systemic risk.

We also want to call attention to the fact that option 1 needs clarification regarding the meaning of “a hedging instrument that exactly matches the IRT”. It is not clear what kind of hedging instruments would fulfil the “exactly matches” requirement.

The revised standardised approach for market risk

We appreciate that the Basel Committee has chosen to progress with the sensitivity based approach rather than the previously proposed cash-flow based approach. We believe that a sensitivity based approach better reflects the risk in the trading book.

We support that the disallowance factor does not become mandatory but only an option for banks. The main reason is that the disallowance factor easily can lead to large discontinuous jumps in the capital charge for near-to-perfectly hedged portfolios, when small changes of the underlying risk factors occur, also known as cliff effects. This is an unwanted behaviour of the capital charge. Further, we seek clarification how to handle general interest rate risks not directly referenced by inter-bank rates, i.e. what defines a distinct interest rate curve in the framework. We see a risk that GIRR will have to be calculated for a large number of distinct curves if each specific interest rate risk has to be handled separately, making it computationally intensive.

Regarding offsetting between positions, paragraph 7 on page 21 in the draft accord text in Annex 1 states that “Prior to applying the calculations in this section, positions in the same risk factor should be fully offset”. It is not clear to us what positions in the same *risk factor* means. Would this imply that interest rate risk from two bonds, one long and one short, with different issuers but same maturity and currency can be offset?

Although the definition of risk factor has been clarified, we seek further clarification regarding risk factor definitions in the GIRR framework. This is in particular relevant for interest rates not directly referenced by interbank rates.

We disagree with the proposal that “market rates” rather than “zero coupon rates” should be used to construct the risk-free yield curve for general interest rate risk (paragraph 20 on page 25). It is very hard to build consistent yield curves directly from market rates. The market practice is to generate zero coupon yield curves based on market rates and then use those zero coupon yields as risk factors. This is the approach we recommend here as well.

We see the change in the treatment of curvature and vega risks as a step in the right direction. However, its impact should be calibrated carefully as delta, curvature and vega capital components are aggregated independently of each other.

We seek clarification what the equity repo risk factor is referring to. Our understanding is that the interest rate risk of an equity repo should be covered under the GIRR framework which would lead to double-counting if it were to be added under the equity framework as well. We also seek clarification on the definition of equity dividend risk factors as these can be expressed either as discrete dividends or dividend yields.

Some of the prescribed curvature scenarios are invalid. E.g. shifting credit curves down by 250-1200 basis points will send most credit curves into negative spreads. Also, even when spreads stay positive some curves will be inconsistent and/or include arbitrage violations (too steep to build). Therefore, in particular the curvature scenario shifting market data down is problematic. Banks could apply a “best fit” shift instead of the prescribed bump (e.g. floor the credit spreads at zero), but this would lead to problems with comparing the scenario revaluation with the delta approximation (the last term in the CVR_k formula). A simple solution to avoid that could be to formulate a curvature charge based on absolute changes in a single scenario where market data is shifted up.

Parallel shifts of risk factors are introduced for the curvature risk (CVR) of GIRR and CSR. In the CVR formulas, the delta risk is subtracted from the full revaluation values, as the delta risk should not be included twice. As an alternative, the non-parallel shifts from the delta risk could be used for calculating all relevant terms in the CVR formula instead of using parallel shifts.

The relative risk weight for vega risk is proposed to be 0.55 for the 10-day base horizon. The liquidity horizons for equities are 20 days for large caps and 120 days for small caps, hence the basis risk weight is scaled by $\sqrt{\frac{20}{10}}$ and $\sqrt{\frac{120}{10}}$ respectively.

Empirical evidence from the VIX volatility index with 15 years of daily observations, beginning 03 January 2000, indicates that 0.55 as base risk weight is excessive. Based on the VIX data, we find that 0.46 is a more fair base value than 0.55. Details will be provided upon request.

Correlations for credit spread risk (page 31 in the CP): some entries in the matrix are problematic. Buckets j and $j+6$ are for same sector but for different credit quality (IG/HY). Therefore it is problematic that e.g. $\text{corr}(3,9)=0\%$ and $\text{corr}(3,12)=40\%$. Similar problems exist elsewhere in the correlation matrix. Entries $\text{corr}(j,j+6)$ should be relatively higher.

Despite Correlation Trading Portfolio (CTP) now being recognized, specifically, netting will be limited in the default risk charge, with no netting across tranches and across portfolios (even for index series). The framework allows some degree of overall hedging and diversification, but this does not sufficiently incentivize hedging

and overstates the real risk of a well-managed CTP, e.g. the name-specific hedging performed by banks in practice will not be acknowledged.

Non-securitisation hedges of CTP are to be removed from the default risk non-securitisation calculation according to paragraph 88 of CP3. We kindly ask the Committee to confirm that a similar approach also holds for non-securitisation hedges of non-CTP securitisations or advise otherwise.

Vega risk (VR) correlations. With respect to vega risk correlations in general, our understanding is that vega risk correlations effect are only measured across ATM volatility risk. No smile correlations are to be calculated. The capital calculation “across smiles” is simply done by addition. We would like the Committee to confirm this or advise otherwise.

We support the use of the look-through approach for indices but stress the need for a feasible fall back option. This applies in particular for non-linear instruments, such as index options, where splitting the risk into constituents based on index weights might not always yield meaningful results. We therefore suggest that the effect of using index weights compared to the index itself should be tested in a future QIS.

We question the allocation of equity risk based on most material region rather than the equity market where the equity is mainly traded. As the aim of the framework is to measure market risk rather than company risk we see the market where the equity is listed as the more relevant classification.

Although we appreciate the need of a general framework in the standardised approach with broad risk factor groups, when it comes to the risk weights for credit spreads in the standardised approach we find some of the shocks applied overly conservative, in particular as offsetting exposures to the same issuer are not fully allowed. For instance a AAA rated covered bond issued by a financial issuer would be shocked by 500 basis points. We also find some of the shocks internally inconsistent, e.g. the risk weight for investment grade sovereigns is 250 basis points, which is higher than that of investment grade sub-sovereigns at 200 basis points. We would therefore again like to stress the need of a thorough calibration period to make sure that the new framework does not lead to unintended results.

Incorporating the risk of market illiquidity in the internal models approach

In the approach to ES models with varying liquidity horizons set out in the second consultative document, the ES model was required to model the risk factor shocks over the actual length of a given liquidity horizon without approximations or scaling from shorter horizons. This approach has been revised in the present consultative

document to employ an approximation based on scaling of ES calculated at a base horizon to the length of the longer horizons. We welcome the change as it would simplify the implementation. However, we note that the change leads to increased computational complexity. ES has to be calculated both for all risk factors and for subsets of risk factors with longer liquidity horizons, leading to an increase of five times in the number of ES calculations.

We would also like to stress the importance of calibration of the cascading formula; for long liquidity horizons the square root of time rule may be overly conservative. This was pointed out at a meeting on the 14 January 2015 between the Committee's Trading Book Group and the ISDA working group, where the ISDA working group proposed the introduction of a so-called de-risking profile when scaling risk along liquidity horizons in the IMA. The de-risking profile reflects that, when risk is offloaded, it is normally offloaded gradually until the end of the liquidity horizon, not in one large bulk at the end of the liquidity horizon - which is an implicit assumption with the current formulation of the IMA. We support this proposal from ISDA. If a linear de-risking profile is assumed, and the risk is assumed to be governed by a Wiener process, it is straightforward to show that the time scaling factor is changed from $\sqrt{T}$ to $\sqrt{T/3}$, where T denotes the liquidity horizon. Detailed calculations will be provided upon request

In paragraph 181 point k on page 20, the liquidity horizons for different risk factor categories are set out. For FX rates, a distinction is made between liquid currency pairs and other currency pairs. However, we are of the opinion that when two currency pairs are liquid, the combination of those two are liquid as well. Put differently, transitivity between liquid currency pairs should apply. The reason for this is that to arrive at the third currency, a bank would make a deal in each currency pair concurrently. For instance, two of the currency pairs that are deemed to be liquid according to the proposal are USD/EUR and USD/SEK. If a bank would execute two trades at the same time, one in the liquid currency pair USD/EUR and one in the liquid currency pair USD/SEK, then that would effectively create a trade in EUR/SEK, which thus reasonably also could be deemed to be liquid.

If the Committee would not agree on transitivity between liquid currency pairs to apply, we are of the opinion that EUR/SEK as well as NOK/SEK should also be regarded as liquid currency pairs. As evidence of the liquidity of EUR/SEK, it could be noted that in the electronic matching application Thomson Reuters Matching, SEK/EUR is quoted while USD/SEK is not. Hence, as the Committee suggests USD/SEK to be liquid, in our view SEK/EUR should be regarded as liquid as well.

Actual and hypothetical P&L

In the second consultative document, the problems of back testing against actual P&L are described in detail. In the updated rules text draft in Annex 4 of "Instructions for Basel III monitoring" from January 2015, both actual and hypothetical P&L are defined and it is stated that back testing should be done against both measures. As back testing against actual P&L will include effects, such as theta and carry, which are not covered in the risk measurement model, there' is a risk that back testing breaches will occur due to parameters not modelled in the risk model. We therefore recommend that back testing will be performed against hypothetical P&L and that the requirement to back test on actual P&L will be removed.

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