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Secretariat of the Basel Committee
on Banking Supervision (BCBS)
Bank For International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

Doc Ref: GARYH/#241389_V3
Your ref: d436
Direct ☎: +27 11 645-6708
E-✉: garyh@banking.org.za

Dear Sirs / Madam

Re: Revisions to the Minimum Capital Requirements for Market Risk

We thank you for the opportunity to respond to your consultative document (d436) issued on 22 March 2018. We support the industry engagement which intends to address the issues identified in the course of monitoring the implementation and impact of the Standards. The feedback submitted herewith is geared towards strengthening the trading book capital framework whilst aiming to minimize unnecessary complexity and unintended consequences, where possible. We are also supportive of the revised implementation date.

This updated consultative document incorporated a number of calibration changes and new approaches which our members support. These are reflective of the active engagement of the BIS Market Risk Group (MRG) with industry since the Minimum Capital Requirements for Market Risk Standard (d352) was released in January 2016.

We continue to believe that the exchange of views between industry and regulators remains the most efficient and effective way of developing solutions and proposals in line with the stated regulatory policy objectives. We also acknowledge that the FRTB objectives do not include raising the capital requirements in the trading book.

We have captured our comments to the consultative document on **Annexure A**.

We would like to reiterate that we fully support the objectives of FRTB to reform regulatory standards for banks in response to the financial crisis. While the release of the Consultative Document and updated FAQ by the BCBS provides clarification for certain market risk capital requirements, additional engagement / guidance is required on the following key aspects:

- **Standardised Approach "Default Risk Charge"**

Given the MRG / industry meeting in January, the outcome of which seems to indicate that if IMA is used, it must be used for all calculations.

Guidance is still required on whether banks can continue using the standardized approach for calculating DRC, if they use the IMA model under FRTB?

- **Risk weighting to be applied to sovereign exposure in local currency**

Section 3 (i)(a)(ii) in Paragraph 59 of the January 2016 Minimum Capital Requirements for Market Risk refers:

“When data on market-implied swap curves described in (a)(i) is insufficient, the risk-free yield curve may be derived from the most appropriate sovereign bond curve for a given currency. In such a case the sensitivities related to sovereign bonds is not exempt from the credit spread risk charge: when a bank cannot perform the decomposition $y = r + cs$, any sensitivity of cs to y is allocated to the GIRR and to CSR risk classes as appropriate with the risk factor and sensitivity definitions in the standardised approach. Applying swap curves to bond-derived sensitivities for GIRR will not change the requirement for basis risk to be captured between bond and CDS curves in the CSR risk class”.

The December 2017 BIS paper on “The Regulatory Treatment of Sovereign Exposures” (page 20) further reinforced this view:

*“The revised market risk framework includes a standardised approach and an internal models approach. The standardised approach capital requirement is the sum of three components: the default risk charge, the risk charges under the sensitivities-based method and the residual risk add-on charge. At national discretion, claims on sovereigns, PSEs and MDBs may be subject to a zero default risk weight. **A preferential treatment is not applied for sovereign exposures when calculating the credit spread risk and general interest rate risk charges”.***

Should a sovereign bond in domestic currency have a non-investment grade rating, it will attract a 3% risk weighting in addition to the capital charge for GIRR. If this bond is hedged through and asset swap, only the GIRR capital charge will be offset with the CSR capital charge remaining unhedged.

Our concern is that this will cause the following inconsistent behaviour:

- A sovereign bond in domestic and foreign currency will attract the same credit spread risk charge even though the sovereign curve in domestic currency is recognized as a proxy for the risk-free yield curve as per the December 2017 discussion paper “The Regulatory Treatment of Sovereign Exposures”. This paper also distinguishes on page 26, between domestic and foreign currency risk which will be ignored under the proposed treatment.
- Domestic-currency central government exposures could be subject to lower risk weights than foreign-currency central government exposures. This reflects the Committee’s view that such exposures are relatively less risky and that they play an important role in financial markets (e.g. for liquidity management purposes). These risk weights could also apply to all exposures to MDBs that are currently subject to a 0% risk weight treatment.
- Recognizing the difference in risk of a domestic and foreign currency bond for the default risk charge, but not for credit spread risk leads to inconsistent recognition of credit risk.
 - There is no market for credit derivatives referencing domestic currency sovereign risk which (1) supports the understanding that this there is not credit spread risk and (2) results in attracting a large capital charge for something that cannot economically be hedged.
 - Inconsistent recognition of risk between the Internal Model Approach and the Standardised Approach as no scenarios will exist for credit spread risk on domestic currency sovereign bonds.

• **Internal Risk Transfers (IRTs)**

We seek further clarity regarding the prudential need for the proposed restrictions on IRTs. In particular, we propose that banks retain the ability to transfer banking book risk to the trading book in a way that allows the risks to be managed on a portfolio

basis, taking into account diversification effects, subject to the trading book regulatory capital requirements, the limits of the trading book and governance standards that meet supervisory approval. This approach enables more effective management of banking book hedging given that sufficient market liquidity and depth may not be available to apply exactly matched external hedges in less developed markets. Enhanced transparency on risk transfers is supported in order to mitigate the risk of capital arbitrage, however the current restrictions may cause unintended real economy consequences in terms of the natural provision of hedging for interest rate risk hedging by Corporates (generally payers of fixed rates via the trading book) for Treasuries (receivers of fixed rates), liquidity, pricing, etc.

- **QIS and timeline**

The proposals set out in the consultative document require adequate testing before being introduced in the policy framework. Consequently, we recommend that the next QIS exercise results should seek / inform the final policy framework decisions. It is expected that the standards be finalised by end 2018 in order to allow sufficient time for legislative process, parallel runs, model applications and subsequent go-live deadlines are able to be met.

We look forward to further engagement on these issues above and those raised in Annexure A.

Yours sincerely



G Haylett
Prudential Division



ANNEXURE A

No.	Reference	Comments
1	Standardised Approach	
1.1	Revisions to the treatment of liquid FX pairs	We support the inclusion of additional liquid currency pairs that could be constructed via other liquid currency pairs. An extension of preferable risk weight treatment will reduce the capital requirements for FX exposures, especially in cases where USD is not the reporting currency of the bank, particularly impacting emerging market banks. We support the notion that banks be allowed to apply a lower risk weight to currency pairs triangulated from two specified liquid pairs, thereby allowing banks to apply specified currency treatment to determine risk weights for SA calculation and 10-day liquidity horizon for Expected Shortfall (ES) calculation.
1.2	Revisions to correlation scenarios	We are supportive of the new low correlation scenario. A low correlation floor will reduce the severity of the scenario when aggregating within and across buckets. The low correlation scenario has been observed to produce overly conservative correlations for risk factors that are highly correlated, regardless of market conditions.

1.3	Revisions to capital requirements for non-linear instruments	We are supportive with revisions to the curvature charge for non-linear instruments particularly related to potential long gamma cliff effect. In addition, consistent shock scenario application may simplify the curvature calculation process. The introduction of a floor in the curvature formula addresses the potential cliff effect, while the application of a scalar to curvature sensitivities addresses potential double-counting of FX curvature risk. For consideration: • Clarification on index/multi-underlying options reduce curvature charge operational complexity, particularly in the context of broad-based indices. The addition of a no-look-through approach for index/multi-underlying options curvature charge calculation would reduce the operational complexity for banks, however further analysis is required to assess the application of the highest prescribed delta risk weight. • For Equity Risk the same sector breakdown (as defined in paragraph 102 of the original text) applied to large cap companies should be applied to small cap companies so that emerging market economies are represented adequately.
1.4	Revision of risk weights	We are supportive of the proposed decrease in GIRRR, Equity and FX risk weights. These reductions in risk weights bring the estimated capital impact of the SA in line with its initial expectations. The final recalibration is still pending but is expected to be determined based on further data and feedback provided by banks as part of the next QIS.
1.5	Other clarifications	We are supportive of the clarification of multi-underlying and index instruments.
2	Internal Models Approach	

2.1.1	P&L attribution test	We welcome the clarification of the PLA test definitions and fully support the alignment of input data in the calculation of the test, in addition to the test been calculated on a quarterly basis using a time series of date collected over the preceding 12 months. We also welcome the definition of HPL, actual P&L and RTPL.
2.1.2	PLA test metric design	We believe that it might be too soon to recommend a final test metric design as final internal analysis is still ongoing. We note that : Alternative 1: Kolmogorov-Smirnov (KS) might be a better option due to ease of calculation of date requirements, although it might be more stringent from the point of view of being an absolute-difference measure. Under the Chi square test, this seems to capture more broad distributional characteristics.
2.1.3	PLA test failure consequence	We believe that the introduction of a traffic light approach will smooth desk-level capital volatility and avoid the capital cliff effect going from IMA to SA.
2.1.4	Trading desk requirements	We are supportive of the change.
2.2	Non-modellable risk factors	Requirements for mapping of real price observations to risk factors are clarified, with two bucketing approaches being proposed. With regard to risk factors that represent a point on a curve or a surface, the bucketing alternatives present operational complications, particularly in terms of the linkage between NMRFs and RTPL (i.e. a single curve may have points that are observable and NMRFs, in a full revaluation approach it is not possible to remove the NMRFs from the curve. As a result NMRFs will essentially be included twice).

		Clarifications around data pooling and committed quotes governance requirements (in terms of principals, audit reports, policies, methodologies, etc.) will likely have a significant impact on time series management. For Consideration: • Given the operational burden of identifying and quantifying a stress scenario for each risk factor deemed non-modellable, we proposes a materiality consideration with regard to NMRFs • With regards to extrapolation up to a reasonable distance, we recommend guidelines on what is regarded as “<i>reasonable</i>”. • While supporting the concept that higher capital requirements should be held for models where there may be a lack in consistent, observable data points to ensure that the model predicts risk in a reliable manner, we think that the prescribed rules run the risk of deviating from the true principles that it is trying to capture into a purely mathematical exercise that is moving too far away from the realities of the financial markets. We would urge the committee to seek an approach that does not deteriorate into a purely mathematical exercise which may have unintended consequences that will affect the functioning of trading markets and stifle the development of new markets. • When considering NMRF’s, the MRG should also take into account the Prudential Valuation Adjustments as a mitigate.
	General market data principals	We do have concerns that the new market data principles for banks may have considerable impacts on time series enhancement and business-as-usual management. Banks may experience higher NMRF charges to reflect market data time series model inputs that do not

		appropriately reflect both general and idiosyncratic market risk or are deemed inappropriate for stress period calibration. For consideration: Clarification is sought on whether all risk factors deemed non-modellable are required to be excluded from the ES model or whether these risk factors should only be excluded from the reduced risk factor ES model and may still form part of the overall ES charge. Stripping out bucketed risk factors may prove to be operationally intensive. Market data quality controls and processes might need to be developed to ensure that volatility and correlation data are representative of real price observations. The additional principles may require developing periodic supporting documentation to demonstrate that the listed principles are met using various techniques, requiring further governance and are expected to contribute to additional operational complexity.
2.2.1	Process for satisfying modellability for internal calibration	For consideration: • Further clarity be provided on real price definition, committed quotes and principals for date quality • Alternative 1: Banks specifying their own bucketing structure. Each bank would be able to determine granularity required given their business model and access to market data. • Alternative 2 might be needed to ensure consistency between banks

2.2.2	Impact of NMRF framework on seasonal markets	Given clarity on committed quotes, seasonality concerns are reduced
2.2.3	Impact of NMRF idiosyncratic equity risk	We welcome and support the introduction of a SES
3	Scope of market risk capital requirements	
3.1	Treatment of structural positions	We are supportive of the proposed changes
3.2	Boundary between trading book and banking book	We are supportive of the proposed changes
	General	Additional operational effort may be required to identify trading repos, net investments in EQ funds and the monitoring of net short credit/equity exposure.
4	Simplified alternative to the standardised approach	
	We remain supportive of the proposed methods of scaled Basel II requirements.	