

20.06.2018

Madam / Sir,

Sub: Basel Consultative Document on Revisions to the minimum capital requirements for Market Risk

We refer to Basel Consultative Document on Revisions to the minimum capital requirements for Market Risk, which was issued for comments by 20th June 2018.

The consultative document inter-alia mentions following revisions:

- Treatment of Triangulated Forex pairs as liquid pairs: Certain currency pairs are designated to be sufficiently liquid to warrant lower associated capital. However, two liquid currency pairs can be combined to create a new pair which by virtue of being the result of combining two liquid instruments is also liquid. Unlike earlier version, revised approach classifies the resultant pair as liquid & consequently lower capital requirement.
- Revisions to correlation scenarios: Diversification benefits come from use of correlations in the aggregation of risk factors. In terms of the revised approach, committee is of the view that 'low correlations' scenario can produce correlations that are more conservative than empirical data would support. This can make the outcome of the standardized approach overly conservative. Committee proposes to revise the 'low correlations' scenario to address this issue by limiting reduction in correlations in these areas.
- Revisions to capital requirements for non-linear instruments.
- Reduction in risk weights for general interest rate risk class by 20-40%, equity & forex by 25-50%, so as to bring revised capital requirements closer to originally intended level.



- Simplified alternative to standardized approach: If a Bank opts for simplified alternative, Bank would have to apply a multiplier as detailed below to capital requirements for each risk class of Basel II:

Risk Class	Multiplier
General & Specific Interest rate risk	1.50 -2.00
General & Specific equity risk	3.00 - 3.50
Commodity	1.50 - 2.50
Forex	1.25 -1.50

Recalibrated proposal is intended to make the computation comparable, but slightly more conservative than, the revised full approach.

We hereby submit our suggestions/feedback on the consultative document:

1. Proposed reduced Risk weights are a welcome suggestion. Proposed risk weights are prescribed in 'range' for each vertex/ buckets instead of earlier 'single risk weight' in each vertex/ bucket.

➤ Issues:

- Framework for application of a particular risk weight within the range is not prescribed. For example risk weight proposed for equity in 'bucket 1' is in the range of '27.5% to 41.25%', but the rational/methodology for applying 27.5% or 41.25% or some percentage in between the prescribed range is not defined.

➤ Suggestion/s:

- It would be better if national regulators are given freedom to prescribe the specific risk weight percentage/methodology within this range as proposed in the revised approach.

2. Equity risk:

- In terms of the revised approach, in equity class, sensitivity is assigned to a bucket based on market-cap, economy (advanced or emerging) of the country & the sector in which company falls like consumer goods, telecom, financial, etc.
- Different buckets have different risk weights ranging from 15% to 52.5%.

- Market cap is defined as the sum of the market capitalizations of the same legal entity or group of legal entities across all stock markets globally.
- Large market cap is defined as M-Cap $\geq$ USD 2 bn & small $<$ USD 2 bn

➤ Issue/s:

- 2 billion USD may be a significant amount in an economy, while in another economy the same amount may not be so much significant.
- There may be large variations in M-cap of companies in an economy.
 - In India, company with largest market cap in a stock exchange has a market cap of around USD 100 bn, 3rd largest has a market cap of around USD 50 bn, while the top 100th has a market cap of around USD 4 bn.

➤ Suggestion/s:

- National regulators may be given freedom to prescribe the amount for large or small market cap, as market capitalization amount may differ in various economies. Alternatively, buckets may be assigned based on ratio of Market Cap/ GDP instead of only Market Cap.

➤ Issue/s:

- Market cap is defined as the sum of the market capitalizations of the same legal entity or group of legal entities across all stock markets globally.
- A small transport company in advanced economy having M-cap of $<$ USD 1 bn in a stock exchange may land up with minimum Risk weight of 15% if M-cap is added across stock exchanges instead of minimum 25%.

➤ Suggestion/s:

- Rather than adding the market capitalizations across all stock markets globally, largest M-cap of that company/ legal entity in any stock exchange may be treated as the M-Cap of that company because many

companies are listed in more than one exchange/ country, like many companies issues ADR/GDR, etc.

- Getting data on M-Cap of companies having presence globally would also be a challenge.

➤ Issue/s:

- Higher risk weight is proposed for all sectors in emerging market economies as compared to advanced economies.

➤ Suggestion/s:

- Risk weights proposed for various sectors may be re-looked as riskiness may not be solely determined by stage of economic growth (advanced economy or emerging economy).
 - Recent global financial crises have highlighted that riskiness can be more in advanced economies.

➤ Issue/s:

- A particular sector may be of more importance or given more priority in an economy while the same sector may not be of much importance in another economy. This may depend on the stage of development, employability of the sector, availability of natural resource, proximity to trade centers, technology etc.

➤ Suggestions:

- Accordingly, risk weight may be applicable depending on importance of the sector in the economy. Hence, national regulators may be given freedom to prescribe the risk weight for a particular sector.

3. Credit Spread Risk:

- Credit Spread Risk framework captures the risk that arises due to changes in the present value of cash flows due to changes in credit spread.
- Different Risk weight is applied on different bucket which is based on credit quality ('Investment Grade' or 'High Yield & Non Rated') & sector.
- Sensitivity of a bond is determined by calculating the change in the market value of the bond as a result of change in credit spread by 1 bps. This sensitivity is multiplied by the applicable risk weight.

➤ Issue/s:

- Proposed method of computing sensitivity for credit spread risk reflects more of interest rate sensitivity.

➤ Suggestions:

- Computation of Credit risk spread may be re-looked. It may be based on the matrix of credit spread based on rating, sector & maturity of the bond.

➤ Issue/s:

- Credit spread risk in case of illiquid corporate bonds is not defined in the revised framework.
- In economies where corporate bond market is not developed, credit risk spread is not observable in the market. For arriving at the price of the corporate bond, credit spread as published by benchmark publishing agencies is added to the sovereign yield curve based on the rating of the Bond.

➤ Suggestions:

- Credit Spread Risk may be arrived based on certain percentage of General Interest rate risk to factor the illiquidity.


