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UK Finance response to the Basel Committee on Banking Supervision's consultative document on Revisions to the minimum capital requirements for market risk

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Introduction

UK Finance is pleased to respond on behalf of its members to Basel Committee on Banking Supervision's (BCBS) consultative document on Revisions to the minimum capital requirements for market risk[1].

UK Finance represents nearly 300 of the leading firms providing finance, banking, markets and payments related services in or from the UK. UK Finance was created by combining most of the activities of the Asset Based Finance Association, the British Bankers' Association, the Council of Mortgage Lenders, Financial Fraud Action UK, Payments UK and the UK Cards Association. Our members are large and small, national and regional, domestic and international, corporate and mutual, retail and wholesale, physical and virtual, banks and non-banks. Our members' customers are individuals, corporates, charities, clubs, associations and government bodies, served domestically and cross-border. These customers access a wide range of financial and advisory products and services, essential to their day-today activities. The interests of our members' customers are at the heart of our work.

Many of our internationally active bank members have both banking and trading books and have participated fully in the preparation of responses by other international trade associations to the BCBS's consultation. This response focuses on a number of aspects of the consultation that are relevant for those of our members that are not internationally active and that do not currently have material, if any trading book exposures. As a result of the changes proposed in the consultation paper these banks may suffer the, presumably unintended, consequences of coming within scope of the market risk requirements for the first time.

Trading / Banking book boundary

Section 3.2 of the proposal to revise the Standard seeks to further clarify the categorisation of instruments between the trading book and the banking book. Whilst paragraphs 12 and 13 of the Standard describe certain activities that are considered as trading we feel that the clearest possible guidance needs to be given on how the 'general presumption' in paragraph 16 is to be applied and the way requests for deviations from the presumptive list may be approved by supervisors, in accordance with paragraph 17.

[1] *https://www.bis.org/bcbs/publ/d436.pdf*

The Paragraph 16a list includes “instruments held as accounting trading assets or liabilities”. The default accounting classification of derivatives that do not qualify for a designated hedge accounting relationship is “held for trading”. In our view accounting treatment is not a reliable indicator of trading activity and use of this definition will potentially increase the scope of the application of the Standard beyond the intentions of the Basel Committee, as we understand them.

Banking book portfolio hedges

A bank may purchase derivatives to hedge banking book positions but may not qualify for a designated hedge accounting relationship under IAS39, for example, when executing an instrument to meet an identified market risk across a portfolio of assets and liabilities. Under IFRS9, a bank may be considered a trading business model for accounting purposes, although again the policy and practice is solely to hedge the banking book.

In the situation that a bank did not otherwise have any trading book activities, a strict application of this presumption would therefore force the bank to recognise a Trading Book in relation to its Banking Book hedges.

We support the objective of the categorisation rules to prevent switching instruments between the banking and trading book for regulatory capital arbitrage purposes. But in this particular case a consequence of the categorisation is to create a trading book for an institution that would not otherwise consider itself as engaging in trading book activities.

Where a bank has never previously considered its activities as trading book, changes due to this regulation would force a number of ongoing additional regulatory requirements; including operational practices, risk management policies, increased reporting burdens and additional capital requirements. Moreover, the initial identification and initiation of these requirements would be a considerable burden, as historic consideration of trading book related regulation has been discounted.

The proposed Standard goes on to indicate that permission to deviate from the presumptive list can be obtained by submitting a request to its supervisor, which must then give its explicit approval. Although under this scenario, we would hope a deviation would be granted, uncertainty in the interim period, as regulation develops, causes concern and limits the time to prepare in the event of a negative outcome.

Customer risk management

Similarly, a bank offering derivative products to support customers’ risk management activity in a Banking Book would be expected to apply strict hedging criteria for any resulting exposures. This strict approach can mean that a firm may choose to take a “held for trading” accounting approach as the associated hedging criteria result in minimal net risk and volatility associated with the hedged position. This activity is fully in keeping with Banking Book activity and the accounting approach is not, in our view, a reliable determinant of trading activity.

So, we request the clearest possible guidance be given on the types of activity covered by the proposed revisions. This could be achieved by explaining how the approach to ‘Definition of trading desk’ (paragraphs 22-25) would override paragraph 16, and by permitting supervisors to apply national discretions that do not conflict with the intentions of the revised requirement for minimum requirements for market risk.

Structural separation

Some countries are introducing structural separation of retail banking activities from exposures to financial institutions and trading activities. In the UK this is being introduced by ‘ring-fencing’ structural reform legislation and notably The Financial Services and Markets Act 2000 (Excluded Activities and Prohibitions (EAPO)) Order 2014 (as amended). These prohibit ring-fenced banks from undertaking certain activities but also permit ring-fenced bodies to deal in derivatives as principal for the purpose of reducing its exposure to specified risk factors, including interest rate, currency and liquidity risk.

So, a ring-fenced firm would not be permitted to enter into a derivative transaction in its own name that was increasing its risk to these factors and EAPO also introduces restrictions on the volume of certain derivative products that a ring-fenced bank may provide.

In determining whether to allow a bank to deviate from the presumption according to the process in paragraph 17, supervisors should ensure full consideration is given to the way legal impediments arise that affect the definition of trading book activity according to paragraph 10. Our view is that supervisory discretion should be applied at a national level as this is the most appropriate level to consider national legislation and local practices, such as ring-fencing and a bank's ability to undertake a trading book activity.

Impact on specific instruments

Our members have identified a number of instrument types that may be impacted by the BCBS proposals on minimum capital requirements for market risk. Specifically, we believe UCITS funds and Closed-end funds may be affected disproportionally given the risk that, in our view, they pose.

Undertakings for Collective Investment In Transferable Securities (UCITS) funds are mutual investment vehicles for European investors that provide exposure to securities or other financial assets and which, at the request of the investor can be repurchased or redeemed, directly or indirectly, out of those undertakings' assets. They are regulated in Europe by the UCITS directive.

Closed-end funds (CEFs), also known as Investments Trusts, like UCITS are pooled investment funds but they have a fixed number of shares which are traded on-exchange at a premium or discount to the net asset value of their underlying assets. CEFs are popular with long only/long term retail, pensions and ISA investors due to their diversity and low volatility and makes up approximately 20% of the FTSE250. The majority of CEFs are listed on the London Stock Exchange's (LSE's) main market which are issued in compliance with the EU Prospectus Directive.

Both UCITS and CEFs enable investors to pool their resources in order to invest more cheaply in stocks and shares. The requirements of the BCBS's market risk proposals may create difficulties for mid-tier firms on the Standardised Approach to remain active in these markets.

UCITS funds

The consultation paper introduced additional criteria under paragraph 15a for funds without full daily look-through, whereby only funds meeting such requirements can be designated to the trading book. However, where there daily pricing is available, trading book eligibility should apply where funds are held for the purpose of trading. Examples include funds held to hedge client transactions or the issuance of fund-linked products and dynamically managed on a trading desk with a clearly defined trading / hedging strategy, daily management reporting and risk limits.

CEFs

CEFs

The rules appear to be silent on the treatment of CEFs. The majority of CEFs in Europe are listed on the LSE and trading activity in CEFs is primarily on market making desks, mainly across mid-tier firms that are not G-SIBs. These CEFs will have continuous bid/ask prices quoted on the LSE but without full daily look-through, it is unclear whether these instruments can be held in the trading book where they are managed on a dedicated trading desk with a clearly defined strategy, daily management reporting and risk limits.

We recommend that where a fund (UCITS or CEF) position is managed on a trading desk, a simpler approach be adopted to allow funds with daily pricing but without full daily look-through to remain in the trading book.

Standardised Approach

UCITS funds

There is a lack of clarity on treatment of UCITS funds without full daily look-through, with a potential punitive treatment under the Standardised Approach of UCITS funds that are highly regulated and subject to strict rules on, for example, permitted investments, diversification and liquidity.

CEFs

The treatment of CEFs where full daily look-through is not available is unclear. The potential punitive treatment under the Standardised Approach is likely to adversely impact the ability of market makers to hold inventory to provide liquidity and facilitate client demand, increasing in volatility and cost for end clients in this particular market which is popular with small investors and the pensions industry.

Indices/ETFs

Clarification was provided in paragraph 69 of the consultation paper on the treatment of index instruments under the Standardised Approach where a look-through approach is not adopted. However, the application of the highest risk weight applicable to any of the indices' underlying constituents does not, in our view, reflect the risk of an index position. There is also a disconnect between look-through and how index positions are risk managed and limited on trading desks where there are liquid index option and future markets.

This also applies to liquid ETFs which closely track an equity, bond or diversified financial market index for which there are liquid option markets. Without implementation of full a look-through approach the Standardised Approach is likely to result in a punitive capital charge.

We recommend the inclusion of an additional bucket or buckets for the types of underlyings above where look-through isn't implemented. This approach can ensure sufficient conservatism in the Standardised Approach capital charge which is reflective of the risk of these underlyings.

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