



**AUSTRALIAN BANKERS' ASSOCIATION INC.**

---

David Bell  
Chief Executive Officer

Level 3, 56 Pitt Street  
Sydney NSW 2000  
Telephone: (02) 8298 0417  
Facsimile: (02) 8298 0402

---

13 March 2009

Ms Norah Barger  
Co Chair  
Trading Book Group  
Basel Committee on Banking Supervision  
Bank for International Settlements  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

Dear Ms Barger,

**Proposed changes to the market risk framework**

The Australian Bankers Association Inc. (the ABA) is pleased to have the opportunity to provide feedback on the Basel Committee on Banking Supervision's January 2009 consultative documents.

The feedback is the outcome of deliberation amongst members of the ABA Market Risk Working Group comprised of subject matter experts from the four leading Australian banks<sup>1</sup>.

**Overview**

Australian banks have carried limited exposure to the credit products that have caused unprecedented losses on the trading books of a wide range of offshore banks during the course of the recent turbulence in financial markets. The Australian experience is therefore an opportunity to observe how the existing capital frameworks have performed in the absence of that subset of financial instruments that have caused much distress elsewhere. The ABA's finding is that the existing frameworks have performed well for traditional trading activities even

---

<sup>1</sup> Australian Bankers Association (Secretariat), Australia and New Zealand Banking Group, Commonwealth Bank of Australia, National Australia Bank (Chair), Westpac Banking Corporation

in extremely volatile conditions and that the regulatory capital held against market risks has been sufficient<sup>2</sup>.

Notwithstanding this, it is desirable that capital frameworks be forward-looking and robust to unforeseen events that may (and will) arise in the future. Such unforeseen events can include event risk in those traded risks and products that have previously behaved well.

However, a broad-brush approach risks over-penalising those banks whose trading book focus is upon core highly-liquid, vanilla market risks and products and less upon products that are complex, highly idiosyncratic or less well understood.

Accordingly, the objective of this submission is to propose to the Committee further enhancements and clarifications that will build upon the proposals set forth in the recent consultative documents: *Revisions to the Basel II market risk framework* and *Guidelines for computing capital for incremental risk in the trading book*.

### **Revisions to the Basel II market risk framework**

The ABA welcomes proposals intended to smooth the capital measure and dampen procyclical effects. The Stressed VaR concept is a valuable step forward in seeking to mitigate procyclicality in the regulatory capital formula for general market risk.

However, it is suggested that the proposed amendment in paragraph 718(LXXVI)(j) of the consultative document that sVaR be treated additively with VaR is problematic. The additive approach is likely to lead to a (more than) double-counting of all general market risks within the regulatory capital framework irrespective of the source of that risk. Whilst the capital framework must be forward-looking, it is also the case that a range of core traded market risks and products were "stress tested" by the events of 2008, yet continued to function effectively and with sufficient liquidity within a ten day holding period. The effective doubling of capital requirements for exposures to such instruments, to a level probably intended for products that have not performed well, is likely to lead to risk capital not being allocated in an effective manner to the positions of highest likely risk impact and may lead to counter-intuitive trading book behaviours.

Furthermore, the additive approach provides little discretion to local regulators who must apply the additive methodology even to those banks whose trading books are primarily composed of positions in liquid, vanilla and homogeneous financial instruments.

In order to further enhance the positive outcomes intended by Committee's proposals, it is recommended that the multiplied sVaR become the floor in the capital formula. An additional measure will be added to this floor based on the

---

<sup>2</sup> Backtesting results and capital comparisons can be found in major Australian bank Pillar 3 disclosures.

current regulatory VaR multiplied by a second multiplication factor,  $b$ , being the sum of one plus the “plus factor” arising from back testing or by agreement with the local regulator.

Accordingly, the capital requirement ( $c$ ) migrates from:

$$c = \max \{ VaR_{t-1}; m_b \cdot VaR_{avg} \}$$

to:

$$c = \max \{ VaR_{t-1}; b \cdot VaR_{avg} \} + \max \{ sVaR_{t-1}; m \cdot sVaR_{avg} \}$$

rather than:

$$c = \max \{ VaR_{t-1}; m_b \cdot VaR_{avg} \} + \max \{ sVaR_{t-1}; m \cdot sVaR_{avg} \}$$

The perceived advantages of this approach are that:

1. since the multiplication factor  $b$  will take the range 1 – 2, the outcome for the capital required to support general market risk under the proposed amendment will be above the sVaR floor but remain responsive to the trading book risk, as reflected by the current VaR measure; and
2. local regulators are afforded the ability to impose a multiple of VaR in the capital measure that reflects the scale and nature a bank's trading book activity. This provides a positive incentive to banks to target highly liquid, less complex trading activities rather than those that are complex and less liquid yet which generate a comparable VaR.

It is important to note that “regular” VaR, based upon a minimum monthly update of historical data, will remain at the very core of the tools and techniques that banks use to understand market risk on the trading book. Not only will VaR remain a determinant of the “plus” factor in the capital formula via the outcome of back testing analysis but also it will be the most relevant measure by which a bank can understand the current economic risk embedded in the trading book.

Finally, we understand the motives of the Basel committee are to (i) increase capital requirements in the trading book and (ii) reduce the procyclicality that exists in trading book capital. We believe sVaR should be used predominantly to address point (ii), while point (i) is addressed by the incremental risk charge, and is discussed below.

### **Guidelines for computing capital for incremental risk in the trading book**

The ABA supports the motivation of the Incremental Risk Charge (IRC). It is clear that the assumed trading book holding period and coverage of a 99% VaR measure, based on a recent history set, has in some markets and in certain asset classes been insufficient to capture those events that can arise and become material drivers of gain or loss.

In respect of the proposed IRC principles, it is as yet not clear that additional sophisticated model based drivers (which are incapable of being rigorously and objectively back tested) will lead to more appropriate capital outcomes. It is

inevitable that the development of IRC models will be complex, time-consuming and expensive – and exposed to model arbitrage by trading desks. Furthermore, a “constant risk” (or even a “constant position”) model of trading book positions in credit products over a one-year horizon is not one that reflects the fluid nature of a trading book; particularly one for which additional capital has been allocated via the sVaR mechanism. The proposed IRC model assumptions may fail to meet the “use test” requirements of paragraph 35 of the consultative document. In extremis, a bank would manage its trading book on a run-off basis and it is on these terms that the IRC should be calculated.

At many institutions, and in the presence of constrained resources, it seems likely that such modelling will divert attention from the more beneficial enhancement of Advanced Internal Ratings Based credit portfolio models for core banking book activities. In fact, it is by no means clear that an internal model for specific risk incorporating IRC will in practice deliver a capital outcome that:

1. is materially different to that of the Standardised Approach to the extent that the cost, development, implementation and ongoing support of an IRC model is warranted;
2. is lower than that of the IRB approach that would prevail were the position on the banking book; and
3. will drive better trading and management oversight behaviours.

In the event that portfolios of particular characteristics appear to deliver an internal model capital outcome little different from that of the IRB approach for the banking book, or even exceeds that indicated by the IRB approach, banks may reasonably seek to opt for banking book treatment via well-established and more firmly embedded IRB models and thereby avoid the distraction of the financial and resource cost of another model for little gain.

That a trading book might deliver a higher capital charge than that of the banking book for the same or similar instrument must clearly be invalid, given the expectation that the instrument can only be held in the trading book for a short time.

In response to the Committee’s questions posed in paragraphs 40 and 42 of the consultative document, the ABA’s recommendation is that the IRB, the Standardised Approach and securitisation charges that are applicable to the banking book should indeed also be applied to those positions that do not meet stringent trading book eligibility criteria on an ongoing basis.

In light of the foregoing considerations, the ABA believes that firmer principle-based guidelines on what types of instruments or positions are eligible for trading book treatment would be a simpler and in the longer term a more effective way of materially achieving the goals of the IRC. The ABA proposes to define illiquid (and stale) positions as those that do not meet a stringent trading book definition, in line with the original spirit of the trading book, as being a place for holding liquid positions for the purposes of benefiting from short term market moves.

Based on the Australian Prudential Regulation Authority's prudential standard for market risk (APS 116), the ABA recommends that the definition should consider aspects such as trading book positions in securities having:

1. demonstrable ongoing market liquidity;
2. transparency of pricing;
3. acceptable concentration relative to the bank's portfolio and market size; and
4. a strict maximum holding period (such as 180 days) for individual positions that do not form part of a hedge;

with allowances made to cater for Central bank repo-eligible liquid asset holdings (with appropriate regulator approval) to also receive trading book treatment. Positions not fulfilling these criteria would need to be held under a banking book capital treatment<sup>3</sup>. Regular reviews of trading book positions would be conducted to assess and, if necessary, reclassify positions for banking book treatment.

Whilst the development of internal models incorporating the IRC is supported, it is therefore proposed that the Committee confirm that:

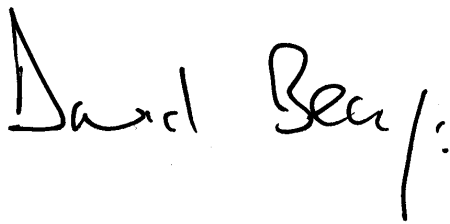
1. the capital outcome for the specific risk of a position under the internal model method is capped at the outcome derived from applying banking book treatment to the same position;
2. for liquid positions that meet stringent and objective trading book criteria (as defined above) specific risk modelling not incorporating IRC be acceptable with the retention of the surcharge to compensate. An increased size of the surcharge could be used to provide some incentive to move to IRC modelling. In this way banks that do not develop IRC models are not forced to abandon existing specific risk models and revert back to the standardised approach;
3. for those banks on either the Standardised Approach or a specific risk internal model that does not incorporate the IRC add-on, Banking book capital treatment will apply to all positions that fail to meet the stringent and objective trading book eligibility requirements on an ongoing basis;
4. banks may elect for banking book treatment as an alternative to either the Standardised Approach (to allow for simplification through the consistent treatment of illiquid and liquid positions) or specific risk internal models; and
5. specific risk and IRC should be defined carefully to avoid any overlap and to facilitate ongoing testing of models.

---

<sup>3</sup> This position is entirely consistent with 'available for sale' accounting whereby a position is held in the banking book (and attracts banking book capital) yet is marked to market on a daily basis.

As a final comment, we believe that for banks adopting IRC modelling, no minimum liquidity horizon should be set by the Committee. Setting a minimum potentially penalises liquid positions over less liquid ones and may create distortions in the assignment of capital, thereby having unintended consequences. Our preference would be to leave the setting of such a minimum in the hands of the local regulators, such that they can set a number that is appropriate to local conditions and to the portfolios of each individual bank.

Yours sincerely

A handwritten signature in black ink that reads "David Bell". The signature is written in a cursive, slightly slanted style. The first name "David" is followed by a space and then the last name "Bell". The signature is positioned above a horizontal line.

---

**David Bell**

**Cc:** Mike Stockley, Chair, ABA Market Risk Working Group