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Guidelines for computing capital for incremental risk in the trading book, Febelfin comment

Brussels, 09/03/2009,

Dear Sir,

Febelfin, i.e. the Federation which regroups four trade associations from the Belgian financial industry¹, welcomes the opportunity to express its views on the consultation paper mentioned above. Following the decision of our Board meeting on 27th February 2009, we would like to make the following remarks.

By introducing major changes in the treatment of market risk, we believe that the proposals set out by the Basel Committee will fundamentally change the way market risk is managed. As a consequence, the proposal will require substantial changes in the risk management process, in the modeling developments (in particular for the IRC proposals), and in the front office. In this respect we welcome the deadline of 31 December 2010 to give time to adapt the required changes.

In particular concerning the use of the standard method for (re)securitization in the trading book, we would welcome more guidance.

However, the treatment of (re)securitization does not form the only area of concern to banks in these guidelines. It is worth noticing that the impact of each proposed change will vary very much depending of the composition of the trading book of each bank. In Belgium, the impact may vary considerably between banks.

We therefore encourage the Basel Committee to undertake a sound analysis to assess the impact of changes to the trading book capital framework, by taking a large sample of banks. The calibration of the market risk framework should be done in light of the results of the impact assessment taking into account the variety of trading book profiles of banks.

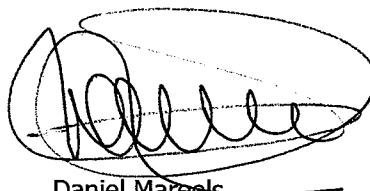
¹ The following trade associations are part of Febelfin: the Belgian Bankers' and Stockbroking Firms' Association (ABB/BVB); the Professional Union of Credit Providers (UPC/BVK); the Belgian Association of Asset Managers (BEAMA); the Belgian Leasing Association (BLA).

This is all the more true considering the proposal to extend the banking book treatment towards the trading book. While we do not oppose such an extension in principle, we note that all consequences of it should be considered very carefully beforehand.

In our annex we provide more detail on this possible extension along with other remarks. We hope these remarks will be taken into account. Please do not hesitate to contact our services and our working group, should you want any further information.



Michel Vermaerke
Chief Executive Officer



Daniel Mareels
Director Taxation & Prudential,
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cc. Mr. J.P. Servais, Chairman of the Banking, Finance and Insurance Commission

Guidelines for computing capital for incremental risk in the trading book, Febelfin comment

General comments

By introducing major changes in the treatment of market risk, we believe that the proposals set out by the Basel Committee will fundamentally change the way the market risk is managed. A lot of resources to adapt to this proposals will be required.

Three major changes are proposed that will impact heavily the risk weighted assets calculated for the market risk:

- to add a Stressed VaR by using the VaR model with historical scenarii related to 2007/2008 on internal model scope;
- to incorporate the incremental default risk charge (IRC), including default risk and rating migration risk;
- to use the standard method for (re)-securitization products in the trading book.

In addition to these proposed changes, some qualitative requirements aiming at fostering the risk management and further management control are imposed.

It is worth noticing that the impact of each proposed change will vary greatly depending of the composition of the trading book of each bank. In Belgium, the impact may vary considerably between banks. For one bank, the proposed stressed VaR as well as the IRC proposal will have an important impact on the way the market risk is managed. For another bank, this is the use of the standardised method for securitisation products which has a bigger impact.

We therefore encourage the Basel Committee to undertake a sound analysis to assess the impact of changes to the trading book capital framework, by taking a large sample of banks. The calibration of the market risk framework should be done in light of the results of the impact assessment taking into account the variety of trading book profiles of banks.

In general, the proposal will require substantial changes in the risk management process, in the modeling developments (in particular for the IRC proposals), and in the front office. In this respect we welcome the deadline of 31 December 2010 to give time to adapt the required changes.

Detailed comments

a) Definition of / scope of securitisations and resecuritisations

In its 2006-document [ref 128, § 539-540], the Basel Committee took a tranching structure (meaning collateralisation and the presence of tranches differing in seniority) as the defining characteristic of a securitisation, rather than collateralisation per se. It is not clear whether this same "tranching" criterion also applies to the new Incremental Risk Charge proposal to pin down the scope of exclusions from Incremental Risk Charge viz. inclusion in the Internal Ratings Based Securitisation framework. We would like to see a clear statement.

Further guidance is needed to pin down securitisations / resecuritisations, especially for the following types :

- position on a (standardized) Credit Default Swap Index (our intuition is to regard this as a credit derivative) ;
- position on a bespoke Collateralised Debt Obligation tranche (our intuition is to regard this as a securitisation or resecuritisation, depending on the underlyers) ;
- position on a Credit Default Swap Index tranche (while not a security, the tranching feature argues for regarding this as a securitisation).

b) Exclusion of (re)securitisations from Incremental Risk Charge-model

Especially for a Collateralised Debt Obligation -warehousing activity, Credit Default Swaps on single names, as well as Credit Default Swap Index tranches, play an important role in hedging the credit risk of Collateralised Debt Obligations viz. of Collateralised Debt Obligation mono-tranches issued by the bank. Note that the bank is BUYING credit protection by issuing the Collateralised Debt Obligation viz. Collateralised Debt Obligation-tranche. Now, from the text of [ref 149, § 10] "A bank is not permitted to incorporate into its Incremental Risk Charge model any securitisation positions, even when securitisation positions are viewed as hedging underlying credit instruments in the Trading book", it seems that the Basel Committee does not allow to distinguish between this case (where the securitisation position is a short credit risk position), and the long credit risk case (as when the bank buys into a Collateralised Debt Obligation-tranche). Clarification is needed whether the exclusion indeed extends to "short credit risk securitisations". Also, given the fundamental change this would constitute, the question arises as to whether the Basel Committee would allow a distinction to be made between existing Collateralised Debt Obligations and new issues, granting partial or total exemption for the existing Collateralised Debt Obligations.

c) Securitisation framework

- The introductory statement which accompanies the new proposal states "for securitised products, the capital charges of the banking book would apply". However, the body of the three new consultative papers does not clearly state this principle. E.g. [ref. 150, §7] states "until the Committee can be satisfied that a methodology adequately captures incremental risks for securitised products, the capital charges of the *standardised* measurement method would be applied to these products" (italics added by us). We would like to see a clear statement that the "Internal Ratings Based" securitisation framework applies equally for Trading and Banking book in the body of the proposals.
- Against the background of the previous bullet, as securitisation exposures which are short credit risk (e.g. a Collateralised Debt Obligation-tranche sold to noteholders) are NOT included in the securitisation framework for a banking book, we read the proposal as stating that for a Collateralised Debt Obligation warehousing activity, only the securitisation exposures which are long credit risk need to be included under the securitisation framework. **We ask for clarification on this issue.**

d) Market Risk Value at Risk model : Specific risk modelling and backtesting

More explicit guidance would be appreciated regarding the requirement of a separate backtest for the Issuer-specific risk component of the Market Risk Value at Risk model.

e) Market Risk Value at Risk model

On page 9 of [ref. 150, § 718(LXXV)], the Basel Committee insists on inclusion of all material risk factors in the market risk Value at Risk model, and, failing that, to motivate the immateriality of any

omitted factors. If this were understood to also apply to entities / banks which rely on the standardised method for Issuer-Specific risk, i.e. whose internal model for market risk – if any – covers general interest rate risk only, then this requirement seems to us to be inconsistent with the principle that it is up to the bank to decide to apply for internal modelling of Issuer-specific risk. **We ask for clarification on this issue.**

f) Scope in terms of risk factors

The new proposal includes default- and migration risk in the Incremental Risk Charge-model, defined as the potential for **direct** loss due to an obligor's default viz. to an obligor's up- or downgrade, as well as the potential for **indirect** losses from the same event [ref. 149, §11]. By its mention of "indirect losses from default or migration", as well as by its requirement to separately model instruments of the same issuer, with explicit reference to "basis risks by product" in [ref. 149, §29], the new proposal sets a target level for regulatory compliance which is very wide open to interpretation. **Additional guidance would be very welcome.**

Reactions to one of the questions of the Basle Committee

In [ref. 149, §39-42] the proposal explores possible routes to take the harmonisation of Trading and Banking book with respect to credit risk further than the current proposal.

In the first route, the Issuer-Specific Pillar 1 capital requirement for the Trading book, whether based on the Standard method or based on Market-Risk Value at Risk + Incremental Risk Charge model would be completely superseded by the Banking book Pillar 1 treatment. The Basel Committee wants the bank industry's view on such a change.

Reaction : it seems to us that the consequences of such a further harmonisation would be far-reaching. As a simple example, take the case of a Credit Default Swap concluded by the Trading book to hedge part of a sold Collateralised Debt Obligation-tranche position. As we understand, subject to certain conditions regarding credit quality of the counterparty vs. the underlying reference entity, the basic principle of Internal Ratings Based Approach is name substitution (i.e. the Credit Default Swap is basically treated as a bank guarantee). By extending this treatment to the Trading book, the regulatory capital treatment of counterparty risk would be affected ; indeed, instead of either computing the Pillar 1 capital on the Credit Default Swap via the Current Exposure or the Potential Exposure based method, the "derivative nature" of the Credit Default Swap would be ignored, and it would be regarded as a bank guarantee extended by the protection seller. Thus, while we are a priori not opposed against further harmonisation, the example illustrates that one should be very carefully in considering further steps.

References

[128] BCBS, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework", June 2006 ("Basel 2")

[148] BCBS, Consultative Doc, "Proposed Enhancements to the Basel II Framework", Jan 2009, issued for comment by April 17, 2009

[149] BCBS, Consultative Doc, "Guidelines for computing capital for incremental risk in the Trading Book", Jan 2009, issued for comment by March 13, 2009

[150] BCBS, Consultative Doc, "Revisions to the Basel II Market Risk Framework", Jan 2009, issued for comment by March 13, 2009