

POSITION PAPER



**ESBG Response to
Basel Committee's public consultations on
Revisions to the Basel II market risk framework (BCBS
148) and Guidelines for computing capital for
incremental risk in the trading book (BCBS 149)**

March 2009



The European Savings Banks Group (ESBG) welcomes the opportunity to comment on the consultative documents issued by the Basel Committee on Banking Supervision entitled “Revisions to the Basel II market risk framework” (BCBS 148) and “Guidelines for computing capital for incremental risk in the trading book” (BCBS 149).

General remarks

The ESBG understands the concerns underpinning the Basel Committee’s proposal for increasing capital requirements to cover market risks and incremental risk in the trading book. However, the solutions proposed entail, in our view, some major problems.

It is essential that capital requirements are in line with the risks incurred by the individual institutions. Therefore, internal models are highly relevant and banks should have incentives to develop them on the basis of their internal risk management processes. Yet, the Basel Committee’s proposals take a largely interventionist approach that, in our view, is likely to discourage further investments in developing internal models and favours an inflexible overall increase of capital requirements without taking due account of the concrete risk profile and portfolio management. Especially in areas where there are no market standards for the time being (such as the modelling of incremental risk), it is very important that the development of models is not limited by strict regulatory specifications. Rigid regulatory guidelines, mainly of a conservative nature, as the ones proposed in the two papers, are likely to invalidate the advantages of internal models.

Furthermore, estimations of the industry indicate that the two regulatory proposals discussed would result in a substantial increase of capital requirements for the trading book. Such multiplication of the capital requirements stems from the proposals regarding the modelling of incremental risks, as well as the introduction of portfolio-independent stressed value-at-risk (VaR). This will annul capital-based incentives for institutions to pass from the standardised market risk approach to a model-based approach.

Moreover, this can also create incentives for avoiding the use of the trading book and trying to ascribe and manage positions as much as possible within the banking book. Legitimate supervisory concerns seeking solutions for avoiding regulatory arbitrage in favour of the trading book risk now to create regulatory arbitrage favouring the banking book (particularly as regards securitisation positions).

ESBG comments on ‘Revisions to the Basel II market risk framework’ (BCBS 148)

The ESBG welcomes the extension of the implementation date to 31 December 2010. The ESBG also expects that, given the substantial quantitative impact of these regulatory requirements and in light of the announced impact assessment in spring this year, the Basel Committee will consult the industry again before finalising the paper.



The proposed changes to the standardised measurement method for market risk raise, in our view, serious concerns. Establishing a unitary specific capital charge of 8% for equities – irrespective of the degree of diversification of the portfolio – is inappropriate. Capital requirements for specific risks should continue to reflect the diversification in the portfolio. The current crisis has shown that risks associated to a diversified portfolio are considerably lower. Therefore, we argue in favour of maintaining the current version of paragraph 718 (xxi) and giving up the proposed changes.

The ESBG is critical as regards the amendments proposed for the specification of market risk factors within a bank's internal market risk measurement system. We do not understand why a risk factor used for valuation in a pricing model would not be incorporated in a VaR model. In our view, irrespective of possible justifications, such a possibility should not be allowed. Furthermore, capturing the non-linear characteristics for options and other relevant products (mortgage-backed securities, tranch exposures or n-th loss positions) is extremely complicated and, in practice, would invalidate parametric VaR models. Also, in our view, the requirement that proxies are used which show a good track-record for the actual position held is not sustainable. Although it is necessary to demonstrate the performance of proxies, the problem consists of not having market prices to contrast the theoretical valuation.

Changes proposed to the quantitative standards applied to the internal models approach to market risk go, in our view, beyond the proposed objectives and are likely to create wrong incentives that would negatively affect the quality of internal risk management and supervisory requirements. The provisions for the determination of 'stressed VaR' will in the future largely determine the calculation of capital requirements and will obviously be higher than the capital requirements of the standard VaR. This implies an impairment of the importance of the standard VaR approach to market risk.

As regards stress testing, too much emphasis is put on concrete historical scenarios, which, in our view, are not appropriate for modelling future stress situations (see "Principles for sound stress testing practices and supervision"). The design of stress testing programmes should not rely on historical risk management or replicate previous stress episodes. Historical experience should serve, at most, to create forward-looking stress scenarios applicable under new market conditions. The choice of scenarios should be much wider.

The proposed changes reflect a highly conservative, additive approach, which does not consider diversification effects, for instance between risks captured in the standard VaR and risks subject to an incremental risk charge. Because of this situation, it appears unnecessary and unreasonable to impose additional add-ons under Pillar 2.

ESBG comments on 'Guidelines for computing capital for incremental risk in the trading book' (BCBS 149)

We believe there is room for further clarification regarding the positions and risks that will need to be covered by the IRC model. It is not straightforward whether all positions included in the trading book are subject to such a charge.

We believe that a 99.9% confidence level and a one-year horizon are overly conservative, especially if we consider the nature of the relevant portfolio, where the holding periods of the positions are less than 3 months. Also, both the time horizon and the confidence level are not in line with the other risk measures normally used for this portfolio.



About ESBG (European Savings Banks Group)

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5215 billion (1 January 2006). It represents the interest of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG Members are typically savings and retail banks or associations thereof. They are often organized in decentralized networks and offer their services throughout their region. ESBG Member banks have reinvested responsibly in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



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