Dear Sir, Madam,

On behalf of the Dutch Banking Association (NVB) I would like to thank you for giving us the opportunity to react to BCBS 254 on the non-internal model method for capitalising counterparty credit risk exposures. The non-internal model method (NIMM) is intended to substitute the currently used ‘current exposure method’ (CEM). An update of CEM is supported, as the CEM produces results that are quite risk insensitive, which results in capital requirements that are not necessarily commensurate to underlying risks. We support the efforts of the Basel Committee to bring the regulatory requirements for the capitalisation of counterparty credit risk in line with actually observed risks, whilst maintaining a level of conservatism that may be expected from a standardised approach. We also value the intention of the Basel Committee to use the NIMM numbers in various areas outside of the capital requirements calculation for counterparty credit risk, such as the leverage ratio, the hypothetical capital calculations by CCPs, the large exposures regime and margining of uncleared trades. A broad application of the NIMM will reduce complexity and will increase comparability of the input data used in various areas. However, next to the clear benefits, there are a number of areas where further improvements could be made. Although we appreciate the desire to keep the standardised method simple, we should seize this opportunity to make the method as accurate as possible, within the restriction that all banks should be able to implement the suggested methods. The proposed changes require adding relatively simple calculations and/or the use of figures which banks that are active in derivatives markets should be capable of performing.

This is the case for:

**Diversification and netting within product classes, especially for interest rates and derivatives**

The current methodology assumes that within the portfolio, for transactions to certain counterparties, the interest rates will simultaneously move in the most adverse direction, even though these movements might be illogical. This seems unduly conservative. We propose that the regulators specify conservative correlations between interest rates of different currencies. This would allow...
institutions to offset short/long positions within an interest rate position within a maturity bucket. After this step, the set off between the currency buckets could be calculated.

A more conservative alternative would be to use supervisory correlations between calculated add-ons. This would not allow banks to set off short and long positions.

The same reasoning applies to FX positions.

**Diversification between product classes**

We understand the hesitation to allow for the incorporation of too much diversification. However, the suggestion to use supervisory correlations was brought forward by the Basel Committee for the measurement of market risk in the fundamental review of the market risk framework. We suggest adopting the same approach for NIMM.

**Sensitivities**

The consultation paper assumes that the sensitivity of interest rate derivatives can be approached via the maturity. This will lead to incorrect figures that are not necessarily conservative. Within a maturity band, incorrect offsetting may take place, because of this crude approximation of sensitivity. We propose to allow banks to use their own sensitivities, as banks are allowed to use their own durations in the standardised method of measuring the market risk of interest rates and debt securities. The starting point of the NIMM is based on internal valuation models. Allowing banks to use their own sensitivities would be fully aligned with current regulation.

The same applies to the use of a fixed delta of 0.5 for options. This is not a priori conservative. Again, banks are allowed within the standardised method for market risk to use their own deltas and gammas for calculation the risk of options. It would be fully consistent to allow banks to use the same sensitivities elsewhere.

We understand that comparability is very important. In this context a possibility would be that banks are given a portfolio of plain vanilla and less plain vanilla derivatives transactions, for which the bank has to calculate the value and sensitivities at each reporting date. This would enable regulators to track differences between banks. Anonymously published results of these calculations could serve as a benchmark, which would help banks assess the uncertainty in their valuation for the purpose of the prudential valuation adjustment.

Alternatives, in order of preference, would be to:

- Describe formulas to calculate DV01s for swaps and other derivatives on the basis of coupons and current rates. For swaps, this could be based on the annuity formula where the annuity is the off market part of the swap coupon. We would gladly provide the Basel Committee some examples. For other more plain vanilla derivatives, including non-linear types, other (approximating) formulas could be developed. In this way, the majority of derivatives could be calculated in a less crude manner.

- Provide a supervisory table of durations. The durations should be dependent on the assumed coupon, keeping the duration stable within a certain range. It would require that this number is not applied to the nominal amount but to the nominal amount inclusive the MTM.

The latter would require that an MTM be calculated for linear derivatives, which form the underlyings for nonlinear derivatives. An alternative would be to also develop supervisory tables for caps/floors and swaptions. This would increase the number of tables. Using internally estimated sensitivities or supervisory formulas would be preferable. We want to re-iterate that this is not intended to make the approach less conservative, but to make it more accurate, avoiding underestimation of the risk. Our members will include samples of the impact of using maturity as an approximation of the interest rate sensitivity - which we feel is not correct - in their QIS submissions.
In case it is decided not to allow banks to use either own sensitivities for linear and nonlinear derivatives, or any of the other alternatives, we advocate carefully determining the nominal amount prescribed for different classes of derivatives.

Multiplier
We appreciate that overcollateralisation is acknowledged through the use of the multiplier in the add-on. We understand that a multiplier based on the assumption of a normal distribution insufficiently acknowledges the possibility of fat tails. However, further clarification of the assumptions used to arrive at the current multiplier would be welcome to enhance our understanding. Care should be taken in ensuring layers of conservatism are not accumulated, especially when the ample use of initial margin is not rewarded.

Inclusion of Margin thresholds in the Replacements costs
In our view, the inclusion of the margin thresholds in the replacement costs is too conservative for margined counterparties with high TH + MTA compared to their RC. In our opinion banks should be allowed to choose between the margined and unimagined approach for margined transactions. In this way, the exposure reflects that it may grow to TH+MTA-NICA, but on the other hand, it will not be bigger than the add-on in case of no margining.

Even though it is not part of this consultation paper and using only method for different purposes is appreciated, we would like to underline that the application of the suggested NIMM in areas such as RWA for CVA risk, Leverage, large exposure etc. should be carefully assessed for its overall impact.

This concludes the main points regarding this consultation. In the annex, you will find the responses to the various questions. Should you have any questions or remarks, please feel free to contact me at your convenience.

Kind regards,

Onno Steins
Advisor Prudential Regulation
Annex – Answers to the specific questions

Q1 - Should the Basel Committee replace the CEM and SM with the NIMM in all areas of the capital framework? What are the benefits and drawbacks of using the NIMM in each of these areas?

A: We support substituting the CEM and SM with NIMM, as this would increase the consistency of the various measures.

Q2 - Is the proposed approach of retaining the general structure of the CEM with respect to replacement cost and the potential future exposure add-on appropriate? Is the division of the broad asset classes appropriate?

A: The retention of the general structure is supported, provided the impact of longer maturities is accounted for in a way that better reflects actual experience (the current proposal appears overly conservative). Also, the Basel Committee uses very conservative assumptions regarding correlations (i.e. fully ignores any diversification between asset classes). This can result in the selection of economically unrealistic scenarios. We suggest adding a table of standard correlations to the framework. In addition, we suggest introducing a correlation table which recognises the diversification benefits between currencies for IR derivatives and currency pairs for FX derivatives.

Q3 - Are there specific product types that are not adequately captured in the outlined categories?

A: We suggest separating the following subtypes out of the commodities product type:
- inflation linked instruments,
- debt instruments (government bond futures (not part of the commodities subset))

In addition, the delta definition for in the money and out of the money options seems not to reflect the risk on these type of trades correctly. For example, a long position in a far in the money option, for which the market risk is hedged with a short position in the relevant underlying, will still show risk in the NIMM approach. This is because the first trade will receive a delta of +0.5 and a delta of -1 is used for the offsetting trade.

Q4 - Does the above approach reflect the replacement cost of margined transactions? Are there any other collateral mechanics that the Basel Committee should consider?

A: The proposed approach appears to accurately reflect the replacement cost of margined transactions. However, banks should be allowed to choose between the margined and unimagined approach for margined transactions, allowing for a better representation of the actual risks. Banks will only have an incentive to choose the unmargined approach for margined transactions if the Threshold + MTA is relatively high. Treating such transactions as an unmargined exposure is a better reflection of the true risk.

Q5 - Of the options under consideration for recognising offset across hedging sets, which treatment is preferred? What number of maturity buckets is appropriate to consider?

A: We advise the Basel Committee to adopt approach 1. Under this approach, distinguishing between three maturity buckets can be sufficient, although increasing the number of buckets (together with high correlations between the buckets) can potentially further improve the model. It is important that the duration is reflected more appropriately.
As stated in the introduction, banks should be allowed to use internally calculated sensitivities. A less preferred option is to use regulatory prescribed formulas which define the interest rate sensitivities. Of course, these formulas should be more risk sensitive compared to the currently defined maturity approach. The least accurate approach would for the regulator to set the duration tables (as suggested by the ISDA). The correctness depends on the swap rate of the transaction versus the swap rate that underlies the table.

**Q6 – Is the proposed approach of using a different methodology for determining the add-on for each asset class appropriate? Is each proposed add-on methodology for each asset class effective at capturing the main risk driver of that asset class?**

A: The general concept of distinguishing between systemic and idiosyncratic components is supported. The add-on methodology does not take maturities below one year into account, which seems strange. Please also our feedback to Q7. We propose to introduce a requirement to calculate the add-on for three maturity buckets (e.g. all maturities, remaining maturities between 3 and 6 months, and remaining maturities in excess of 6 months). These buckets would have to be calculated using appropriate add-ons that fit the maturity profile of the bucket. A bank would then have to use the highest of the three calculated add-ons. Next to this, the concept of “complex” in paragraph 44 is ambiguous. We would appreciate additional guidance from the Basel Committee in this regard.

**Q7 - Are the proposed minimum time risk horizons for each transaction category (unmargin, non-centrally cleared, centrally cleared) appropriate? Should the Basel Committee consider factors other than the IMM for determining the appropriate time risk horizon for the NIMM (e.g. harmonising with other international or national legislation)?**

A: The proposed minimum time horizons seem appropriate for margined trades. For unmarginred trades, however, scaling factors for remaining maturities below 1y should be introduced. Note that currently a 1D EUR/USD FX forward can fully offset a 1Y USD/EUR FX forward with the same notional. This seems to be an undesired effect, which could potentially introduce capital arbitrage trades.

**Q8 - Do the suggested formula and 5% floor appropriately recognise the benefits of overcollateralization?**

A: We understand that the Basel Committee wants to take fat tailed distributions into account. However, the formula and the 5% floor seem to be rather conservative. We would appreciate it if additional information about the calibration of the formula could be provided. Furthermore, the regulation should encourage the placement of sufficient margin on a bilateral basis. As a prerequisite, this should be sufficiently recognised in the PFE formula. Note however that there seems to be a typo in the definition of the multiplier, i.e. we expect that the factor \((1 + \text{floor})\) should be replaced with \((1 - \text{floor})\).

**Q9 - Is the proposed approach to aggregate across asset classes appropriate?**

A: In any case, correlations between FX and interest rate product types should be included. Alternatively, the supervisory correlations proposed as part of the fundamental review of the trading book could also be used in this context. Correlations within the interest domain, between currencies and within the FX domain between currency pairs, should be included.
Q10 - Are there any risk factors that should be included in their own category or accounted for in another manner?

A: As was mentioned in the answer to question one, inflation linked products and bonds should be treated separately. Also, unmarginned sold options should be treated separately; as such deals do not generate any exposure. We propose to exclude unmarginned sold options from the exposure calculation.

Q11 - Is the proposal to introduce the multiplier in order to allow reduction of the PFE add-on in the IMM shortcut method appropriate?

A: Increasing the alignment between the various methods is appreciated and supported, however for credit derivatives; the add-ons should not be symmetrical. Long and short positions behave differently, and there is a downward bias in regards to rating updates.