**September 27, 2017**

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Mr. Coen:

## RE: Consultative Document, Simplified alternative to the standardised approach to market risk capital.

The Institute of International Finance, the International Swaps and Derivatives Association and the Global Financial Markets Association (the "Associations") appreciate the opportunity to comment on the Basel Committee's (the "BCBS" or the "Committee") above-mentioned Consultative Document on a simplified approach to market risk capital (the "Simplified Approach") and in particular the Reduced Sensitivities Based Method ("R-SbM").

The Associations agree that for a number of jurisdictions and for many banks the revised standardised approach[1] (the "Standardised Approach") and in particular the Sensitivities Based Method ("SbM"), may not be appropriate or fit for purpose, considering the operationalization demands of the requirement, relative to their markets and relevant trading book activities. The Associations welcome the Committee's acknowledgement of the challenges faced by these jurisdictions and banks who wish to comply with the Basel market risk framework. We therefore support the objectives of the BCBS in seeking to develop a framework which is more appropriate to those banks whose trading book activity does not justify the investment required to compute the SbM.

On behalf of the industry, the Associations respectfully submit the following comments and recommendations and we look forward to further engagement with the Committee on this important topic.

[1] Basel Committee on Banking Supervision, *Minimum capital requirements for market risk*. January 2016. http://www.bis.org/bcbs/publ/d352.pdf

**Introduction**: While the industry accepts that the trade-off for simplification of the Standardised Approach is a degree of conservatism in the consequent capital requirements, such an approach needs to be proportionate. Industry believes that the proposed calibration of the R-SbM is disproportionately conservative. We note that the latest Basel III Monitoring Report[2] highlights cases of the potential increase in market risk capital requirements compared to Basel II, including that Group 2 banks (which includes those banks for whom the Simplified Approach is intended) will be subject to increases of over 100% of their market risk capital (on a weighted average basis) under the revised market risk standard. The significantly higher risk weights proposed under the R-SbM will further exacerbate the extent of the increase in market risk capital requirements under the Simplified Approach. The proposed framework should incorporate appropriate incentives for adoption so that the banks for whom this approach is intended can and will adopt the methodology as part of their participation in the Basel III framework. As such, the industry recommends that the proposed framework is recalibrated to more appropriate levels.

Further, in order to provide a clearer picture of the potential impact of the Simplified Approach, the industry recommends that, following any adjustments to the framework and proposed calibration which may result from this consultation process, the Committee should undertake quantitative impact studies (QIS) of the proposed Simplified Approach, prior to finalizing the calibration of the standard. Only through conducting a QIS can a clear picture emerge of the potential impact of the proposed framework and banks will be able to gain a better insight into its impacts on their particular business model. The process of conducting QISs will allow the Committee to gain greater insights into the capacity of the banks for whom this framework is intended to undertake the necessary computations as well as those particular areas and elements which may require further adjustment in terms of both approach and calibration. The QIS process would also assist in appropriately calibrating the qualifying criteria. Further, the QIS process may be a means to effectively investigate and compare the alternative option of the conservative calibration of the Basel II framework which is tabled in the Consultative Document.

In the comments below the Associations present the views of the industry in relation to some threshold issues and questions raised in the Consultative Document, followed by comments on specific aspects of the proposed Simplified Approach.

**Complexity**: The Committee has posed the question in the Consultative Document on whether the R-SbM, as proposed, represents a sufficient level of simplification to achieve the stated objectives. The industry acknowledges that removal of the requirement to calculate vega risk capital and curvature risk capital has substantially reduced the calculation burden of the R-SbM relative to the SbM. However the computation requirements in relation to delta risk elements for R-SbM remain too challenging.

The industry would encourage the Committee to consider further simplifications to the R-SbM to reduce complexity and encourage industry adoption of the Simplified Approach. An example of a means to

[2] Basel Committee on Banking Supervision, *Basel III Monitoring Report*, September 2017. https://www.bis.org/bcbs/publ/d416.pdf . While we acknowledge the relatively small sample size of Group 2 banks we note that even for Group 1 banks the increases in market risk capital were in excess of 50%. Further, the Monitoring Report acknowledges that for banks under the Standardised Approach the capital requirements were significantly higher, and such will be the case for all banks eligible for the Simplified Approach.

achieve further simplicity would be through not requiring compliance with a stringent definition of sensitivities but by permitting simple approximations such as duration or maturity based sensitivities of simple interest rates and credit instruments (bonds, swaps). Another example, in relation to a bank's investment in funds (also further discussed later which in this paper), is that the standard should not require a 'look through' approach for such investments (as is the approach proposed under FRTB and which would be extremely burdensome) but instead allow such investments to be treated as if they were equivalent to an exposure to a single stock or issuer.

**Alternative – Amended Basel II**: The Consultative Document acknowledges that the R-SbM is significantly different to the design of the Basel II standardised approach and the implementation challenges and costs may be disproportionate to the relative materiality of the trading book risks of the banks in scope. Therefore, an alternative approach is suggested of a conservative recalibration of the Basel II standardised approach. The industry is interested in further exploring the option of this alternative, and should the form of the Simplified Approach remain too complex, despite potential revision, then an amended form of Basel II standardised approach may be seen as more appropriate. However, it is difficult to arrive at a firm position on this option in the absence of more details as to the proposed amended calibration of the Basel II standardised approach. Industry believes that the recommended QIS process could assist the calibration process. Further, industry recommends that the final simplified market risk framework should provide for a choice between the Simplified Approach and the amended Basel II alternative. Such choice would be subject to the oversight and approval of local supervisory authorities.

**Implementation Timetable**: The Consultative Document proposes aligning implementation of the Simplified Approach with the timing of implementation of the revised market risk framework. This timetable currently proposes implementation of revised standards by January 2019. This timing is not appropriate or achievable for the Simplified Approach. Industry is aware that the Basel Committee is currently undertaking further analysis of the revised market risk approach and through that process the implementation timetable may be amended. Irrespective of the outcome of that review, the implementation timetable for the Simplified Approach needs to provide adequate time for participating banks to develop the required infrastructure to comply with the final standard.

**Scope/application**: The Associations note that the proposed R-SbM is subject to stringent qualitative and quantitative criteria. While it is not explicitly stated in the Consultative Document, it is implied that the criteria are intended to be applied at the group level of a bank. However, in explaining the background to the development of the R-SbM, and its intended scope, we note the following statement in the Document: "*Moreover, in some jurisdictions, large banks face less complex risks*". This statement would suggest that a jurisdictional application is being considered, and that large banking groups are not prima-facie excluded in those jurisdictions where their trading book activities may qualify.

The Associations wish to propose that a jurisdictional application is appropriate for the Simplified Approach. A key objective of the Committee's proposal is to encourage and support those jurisdictions that wish to apply the Basel framework and to further the goal of international harmonization of prudential capital standards.

Access to the Simplified Approach would encourage continued participation of larger banking groups in those jurisdictions by limiting their local compliance burden. This would ensure a deeper market for relevant trading products, provide greater liquidity for users of these products and facilitate the development of the capital markets in what, in many cases, will be emerging market economies.

Applying the qualifying criteria at a jurisdictional level could also benefit certain local supervisors as it will reduce the supervisory burden of assessing compliance with the SbM when the extent of trading activities of market participants may not, of itself, justify the resource investment in this capability.

Therefore, industry recommends that the qualifying criteria should be applied at a legal entity level within each jurisdiction. Under this suggested scope all banking entities that wish to use the Simplified Approach would need to meet the stringent qualifying criteria at a jurisdictional level. Further, the Associations note that the Consultative Document proposes discretionary powers to supervisory authorities to require compliance of banks with SbM despite those banks meeting the qualifying criteria. This would ensure that the local supervisor can prevent use of the R-SbM for those banks for which they deem it is inappropriate. Finally, industry understands that the Simplified Approach will be more conservatively calibrated than the Standardised Approach, and this provides comfort for regulators that entities using the Simplified Approach are more than adequately capitalizing their market risk exposures.

Should this recommendation be adopted, and where a bank meets the criteria for the use of the Simplified Approach in the local jurisdiction (and is permitted to do so by the local regulator in accordance with paragraph 205), they should also be permitted to use the Simplified Approach for that jurisdiction's activities in the group's consolidated capital adequacy calculations. This would reduce the compliance burden and avoid a bank having to invest in two separate calculations: one for local purposes and one for consolidated reporting.

**Eligibility Assessment**: The Consultative Document states that the eligibility determination for the Simplified Approach shall be based on a quarterly assessment and it suggests that the process would be a point-in-time evaluation i.e. as at the end of each quarter. The Document also states that banks should advise supervisors if their trading book exposures exceed the quantitative thresholds which would disqualify them from eligibility to use the R-SbM. The industry would recommend that the eligibility determination in relation to the quantitative thresholds be conducted on the basis of a period of time assessment (i.e. over a period of two consecutive quarters). Should the bank be in breach of the quantitative thresholds over the relevant assessment period, and therefore may no longer be eligible to apply the simplified alternative, then as the next step the framework should prescribe a process of active engagement between the bank and the local supervisor. Further, should this process ultimately result in the bank losing its eligibility to utilize the R-SbM, then an appropriate period of time should be provided for, to allow the bank to develop the required infrastructure to calculate market risk capital using the Standardised Approach (including SbM). Local supervisors should be given discretion to determine, and vary, this compliance period given the particular circumstances.

**Calculation requirement:** The Consultative Document provides no indication as to expected regularity of complying with the calculation requirement for the R-SbM. The paper also states that use of the R-SbM does not exempt banks from computing all other requirements of the Standardised Approach (such as the RRAO and the default risk charge). However, the Standardised Approach incorporates a monthly calculation requirement. The industry believes that the calculation requirement under the Simplified Approach should be a quarterly requirement. This would also correspond with the Eligibility Assessment calculation and determination cycle, which is a quarterly calculation (although the Eligibility Assessment would be made over two successive quarters as per our recommendation). The BCBS has indicated its desire to limit the compliance burden on banks which are eligible to use the Simplified Approach and therefore we would propose that a quarterly calculation requirement would be consistent with this objective.

**Structure of the simplified alternative**: A number of members believe that, should the nature and conformation of a bank's trading book activities qualify them for the R-SbM, then the determination of whether they should also be subject to the residual risk add-on (RRAO) capital charge should be made by the local supervisor. According to the Standardised Approach, the RRAO is intended to capture residual risk which comes about through certain instruments subject to vega or curvature risk capital charges or which fall under the Correlation Trading Portfolio definition (all of which are excluded from the R-SbM) or instruments with exotic underlyings, which in many instances may not satisfy the definitional/qualifying criteria for the R-SbM anyway. Further, in some jurisdictions the trading activities of banks are constrained by supervisors or by the nature of available markets. Consequently, the requirement for the RRAO for eligible banks under the Simplified Approach should be determined on a case by case basis by the local supervisory authority.

**Governance** - With respect to the specific qualifying criteria the Associations propose the following:

- *The bank must not be a G-SIB or a D*-SIB: The Associations recommend that this criterion be removed. The qualifying criteria should pertain to the market risk of the bank, not its overall systemic importance. A bank may be domestically significant for reasons that have nothing to do with their trading book activities and therefore should not be subject to the burden of having to calculate the SbM for what could be a very small trading book. Should a D-SIB satisfy the other criteria then it should be eligible for the R-SbM. We have also recommended earlier that the Scope of the Simplified Approach should be applicable at the jurisdictional/legal entity level, where such requirements exist. Should the Committee agree with this approach then the prohibition on all SIBs should be removed. Also, some supervisors impose limitations on the market risk activities of banks in their regions, so that in effect market risk is jurisdictionally constrained. It would seem inappropriate that banks operating in such jurisdictions should be automatically denied access to the R-SbM purely by virtue of their systemic status.

- *The bank must not be engaged in writing options*: The Industry notes the exemption for writing options when such options are subject to back-to-back arrangements and for covered options, and the industry supports this exemption approach. The Committee may consider including a de-minimis allowance to provide for those situations where a back-to-back arrangement may not be possible at the time of the eligibility assessment and review.

- *Trading book assets and liabilities*: The industry does not believe that "gross fair value of trading book derivative assets and liabilities" is an appropriate measure for defining the threshold for the Simplified Approach. The on-balance sheet value of a derivative mainly represents the counterparty risk on a derivative rather than the market risk. For example, an entity which has transferred all of its market risk to another counterparty through derivatives may record a large derivative asset/liability on the balance sheet while having no exposure to market risk. Conversely, an entity which has entered into a large derivative position, and thus may be exposed to substantial market risk, may record the derivative on its balance sheet at a value close to zero depending upon factors such as the price of the underlying at the reporting date. The industry strongly recommends that the Committee consider defining the threshold based on "net positions" in the trading book (across derivative and non-derivative assets) as currently calculated for the Basel II Market risk rules. These net positions include the value of the underlying even if the derivative is valued at zero. It also allows long and short positions in identical instruments to be offset. This gives a more accurate representation of the positions actually subject to market risk to which an entity may be exposed. We believe that an appropriate threshold could be best determined following the QIS process as we have recommended earlier in this paper.

- *Ratio of total market risk-weighted assets*: The industry believes that the proposed threshold of the ratio of total market risk-weighted assets to total risk-weighted assets of 5% is too low[3]. We believe that an appropriate threshold could be best determined following the QIS process which industry has recommended.

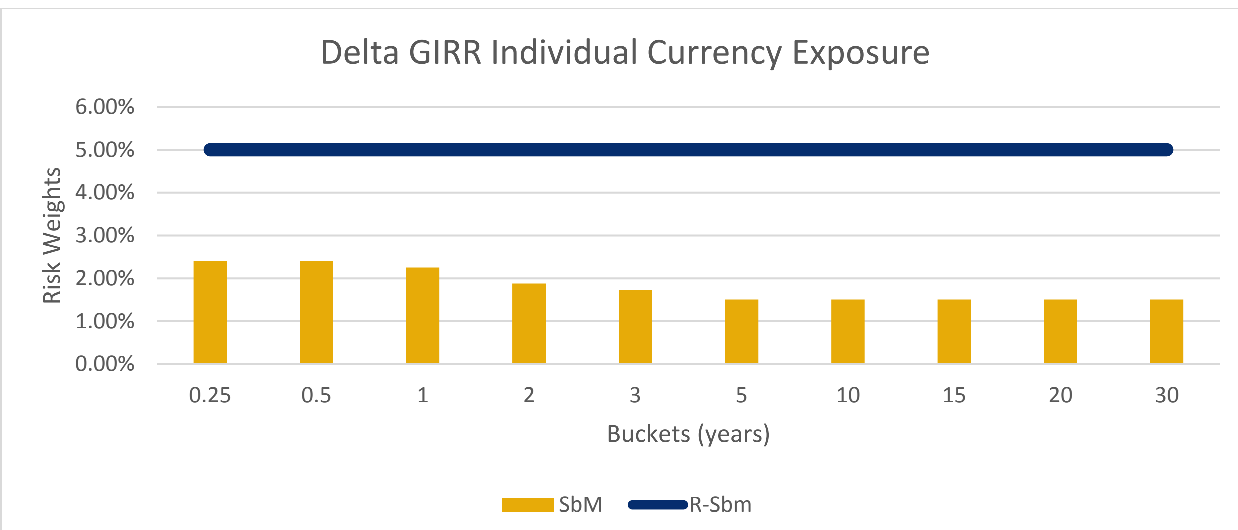
- *[Aggregate notional amount of all non-centrally cleared derivatives (banking book and trading book)]*: The Industry does not understand the rationale behind this criterion and is of the view that it is not appropriate and should be removed. The market risk levels of banks would be adequately captured under the other quantitative criteria. The inclusion of 'banking book' assets goes outside the market risk framework and clearly permeates the trading book/banking book boundary, which is a key component of the broader FRTB framework. Separately, institutions may transact outside CCPs simply because their counterparties are exempted from the obligation of central clearing and many vanilla products cannot be centrally cleared simply because there is no clearing offer from a CCP for such products. For example, that would be the case for relatively illiquid derivatives even though they are vanilla. Moreover, whether or not a

[3] In order to exemplify the conservatism of the proposed eligibility thresholds, the Federation of Brazilian Banks has undertaken analysis that determines that: at the asset threshold of EU1bn - 43% of Brazil's 143 banks would be excluded, including many small, non-complex institutions, and for the market risk weighted assets ratio at 5% - 57% of the 143 banks would be excluded. Consequently a QIS process is recommended on the proposed amended thresholds to determine the appropriate final thresholds.

derivative is centrally cleared impacts the counterparty and CVA risk of the derivative rather than the market risk, so this should not be deciding factor for setting a threshold for a simplified market risk approach. Finally, in many jurisdictions for which this Simplified Approach is proposed, clearing houses may not be available through which to transact and so it is not appropriate to restrict access to the Simplified Approach on the basis of a clearing requirement.

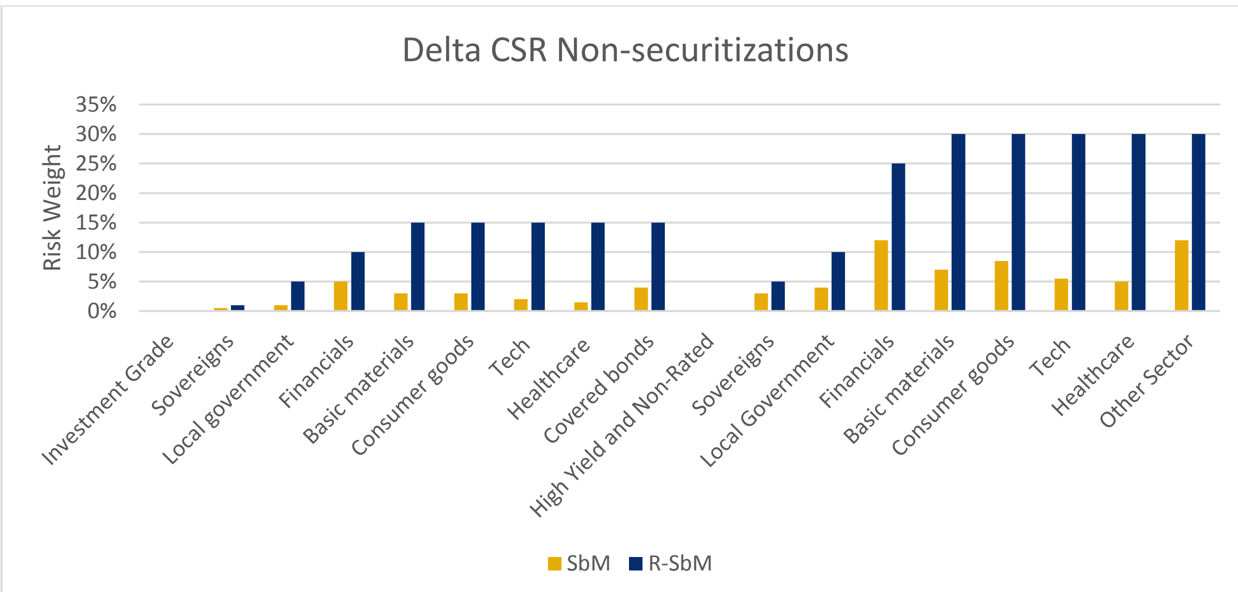
**R-SbM: Prescribed buckets, risk-weights and correlations**

(i) **Delta GIRR**: The industry believes that the risk weight vertices should have more than just two categories of greater or less than 5 years. It would be more appropriate to prescribe at least three time horizon buckets, for short, medium and long-term. Also the risk weights at 5% are too punitive, and are particularly penal for long dated exposures. The industry believes that the proposed risk weights are disproportionate, particularly relative to the proposed weights under the SbM. The extent of the conservatism, and particularly the disparity of treatment of longer dated exposures is clearly demonstrated in the graph below. Also, a flat risk weight across all time periods suggests parallel changes in the curve which does not happen in practice. The industry believes that, similar to the Standardised Approach, for selected currencies by the Basel Committee (being the most actively traded currencies) there should be an adjustment factor (which in the Standardised Approach allows for division of the risk weight by the square root of 2).




(ii) **Delta CSR non-securitisations**: We note that, while the proposed R-SbM includes less granular categorization, some distinct categories should be retained. For example, the industry recommends that there should be a separate category for Covered Bonds in the

Investment Grade grouping. The industry is also of the view that the relative risk weights for this risk class are excessively conservative. For example, under the Investment Grade grouping, the category of Local Government Entities at 5% is five times the risk weight that is proposed under SbM. Also within the Investment Grade grouping the industry points out that under SbM the Other sectors (which are more granular) attract risk weights ranging from 1.5%  to 3.0%. Under the proposed R-SbM these categories attract a risk weight of 15%, five to ten times that proposed under SbM. The situation is mirrored in the High Yield and Non-Rated grouping where the industrial and corporate exposures (collectively the Other category) attract a risk weight of 30%, which is more than three and up to six times the SbM risk weight. The extent of this relative conservatism is clearly demonstrated in the graph below.




(iii) **Delta CSR securitisations**: Industry has similar concerns over the conservatism of the proposed risk weights for this risk class as those expressed for the Delta CSR non-securitisation risk class above, with the risk weights being in some cases up to 6 times higher than the weights proposed under SbM for the same categories. The calibration would likely result in banks under the Simplified Approach not being able to hold securitizations in their trading books.

(iv) **Equity Risk**: The definition thresholds for “Large market cap” and “Small market cap” should be at the discretion of the local supervisor given the circumstances of the local market, and not be a prescribed value.

(v) **Commodity Risk**: No comment.

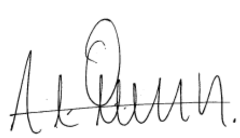
(vi) **Foreign Exchange Risk**: The prescribed risk weight of 45% is considered punitive and represents an increase of 50% above that which is prescribed in the Standardised Approach (which has a risk weight of 30%). Further, the proposed capital requirement for foreign exchange exposures will be a multiple of the current capital requirement under the Basel II framework. Industry has the same view for the specified currency pairs, for which the prescribed risk weight of 32% represents an increase over the Standardised Approach of an approximately similar magnitude. In this context, we note that smaller banks with limited market risk exposures often provide access to FX in emerging market economies. This highly punitive calibration would likely result in those banks limiting their product offering and end-users most dependent on their local banks for access to hedging products would be unable to hedge their currency risks.

**Mutual fund exposures:** The Consultative Document provides no specific guidance on the treatment of exposures to mutual funds. The supervisory authorities in some jurisdictions require that a bank's exposures to mutual funds be included in the trading book. Therefore, the industry would appreciate clarity as to the proposed treatment and calculation approach for mutual fund exposures under the Simplified Approach. Also, in keeping with the objective of the Committee to simplify the approach and reduce the computation burden, as suggested earlier in this letter, one such proposal could be that any specific treatment of the mutual fund class could involve treating such exposures as a single exposure. However, for members in some jurisdictions a look-through approach is already well established and more appropriate. Consequently, the industry would also recommend that any clarification of potential treatment of this class of exposure provide for flexibility, including local supervisory oversight, to account for jurisdictional differences.

**Conclusion**

On behalf of the industry, the Associations would be pleased to discuss any aspects of this industry submission at your convenience. We trust that these comments will help to promote constructive ongoing engagement on this important matter.

Yours faithfully,



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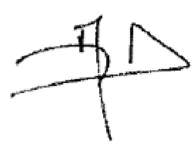

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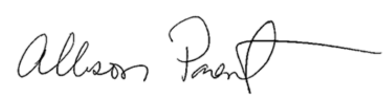

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