European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

2012 International Year of Cooperatives

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland
baselcommittee@bis.org

Brussels, 7 September, 2012
VH/LD/B2/12-146

Consultative Document *"Fundamental review of the trading book"*

Ladies, Gentlemen,

The European Association of Co-operative Banks (EACB) welcomes the opportunity to comment on the Basel Committee on Banking Supervision Consultative Document on "*Fundamental review of the trading book".*

Please find our remarks on the following pages.

We will remain at your disposal,

Yours sincerely,

Hervé Guider
General Manager

Volker Heegemann
Head of Legal Department

EACB Comments on the BCBS consultation on the fundamental review of the trading book

Brussels, August 29, 2012

The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 28 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.000 locally operating banks and 63.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 176 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 50 million members and 750.000 employees and have a total average market share of about 20%.

For further details, please visit www.eurocoopbanks.coop

GENERAL COMMENTS

EACB welcomes the opportunity to comment on the important and far reaching proposal to change the treatment of the trading book instruments. In principle we support the BCBS in its attempt to eliminate the weaknesses of the current framework.

The proposals for both standardized approach and internal model approach have very far reaching consequences for the future market risk measurement. They will require large changes in current model structures, to the internal organization of the banks and thus result in high implementation efforts. This applies not only to the banks with internal models, but to all institutions; they are all expected to introduce the new standard procedures. EACB advises that smaller institutions in particular have to be saved from excessive burdens and to complex approaches.

Since the changes brought by the new rules will be extensive we suggest that all institutions using now the IMM should have the possibility to opt for the SA when it comes into effect.

There is no timeline or indication about when the new proposals should be expected. It is important to determine the planning of further studies based on the proposals (impact analyses and considerations how systems are affected) and to allow for enough time for proper assessments.

We note the intention of Basel Committee to determine fixed correlations between different types of assets. However, fixed regulatory correlations can hardly be determined as these depend on portfolio composition and it is not clear how to allocate one product to the various risk categories. Moreover, by applying externally predetermined correlation parameters, as suggested by the present proposal, the correlations shown in the model are destroyed and replaced by abstract, not internally reproducible model specifications. We acknowledge that there can be large offsetting effects in the VaR that could reverse, leading to losses that are not reflected in the VaR. Therefore, we support a potential reduction of the existing diversification effects dependent on model performance, P&L attribution and following the comparison of the outcomes across banks.

The consultation paper limits the diversification possibilities between risk classes in the case of the internal models, assuming that institutions overestimate them, in particular in stress situations. In our view we cannot really speak of an "internal model", but rather a development toward a "standard model". The regulatory requirements eliminate to a part the natural responsibility of the institutions for their internal model. Banking supervision takes over a good deal of responsibility for the appropriate modelling and model performance in future stress situations. We consider dangerous the no longer clear allocation of responsibility both for banks and for supervisors leading to future problems with model.

The planned structure of the five risk classes (equity, general interest rate risk, credit risk, FX and commodities) does not reflect the current structure of the different risk classes. Particularly the explicit distinction between general and special risk for equity and interest rate instruments is apparently abandoned. This distinction, however, was previously the basis of the partial-use rule. According to that it was allowed, for general interest rate risk to use an internal model and for a particular interest rate risk the standard approach. We have appreciated the opportunity for small banks with internal model, to allow the partial use of their model, without being overwhelmed by a particularly complex and demanding requirements. We consider it desirable, that partial use remains a possibility within the desk approach toward the internal models.

The proposed requirements make internal models less interesting for banks because there is a high probability that the capital requirements will be higher than for the current standardized model. EACB supports the improvement of the internal model framework leading to a more layered approach, that sufficiently takes into account the size and the complexity of trading books and gives more incentives (in capital requirements) for more sophistication in internal model developments.

ANSWERS TO QUESTIONS

Q 01:
Which boundary option do you believe would best address the weaknesses identified with the current boundary, whilst meeting the Committee's objectives?

Support for Trading Evidence Boundary

Of the two proposed options for the trading book boundary, EACB supports the trading evidence boundary. We agree that the banking book-trading book boundary in previous framework might have led to increased arbitrage opportunities. However, the new proposed definition of trading evidence boundary provides an effective solution by backing up the requirement of trading intent with an evidence of this intent.

The assessment for inclusion in the trading book should be done on broad ranges of activities and instruments for reasons of consistency – similar instruments used for similar strategies should be part of the same book.

The flexibility/inflexibility of the boundary should be carefully considered:

- instruments that are in the trading book might become illiquid reflecting more the credit risk;
- instruments that are in the banking book might become liquid reflecting more the market risk;
- new products on new markets might not be from the start allocated to the appropriate book.

EACB members strongly believe that there should ***not*** be a categorical exclusion of the possibility to move instruments from one book to the other.

Arguments against the valuation based boundary

EACB does not support the valuation based boundary because it does not have the desired properties of a new boundary as described in the consultative document in subchapter 3.1.1 page 14.

- Its application seems rather complex and brings little added value, especially for smaller institutions. In addition to the supplementary burden of the assessment of instruments according to the valuation based boundary, the new approach will penalize banks because the diversification and hedges might be torn apart. The risks might be overestimated and the sum of the capital requirements for instruments that are part of hedges and diversification strategies might result in additional CET1 requirements.
- The valuation based boundary will not be consistently applied across banks in different jurisdictions as a consequence of differences of accounting standards across countries. It will have an impact on the scope of the trading book and significant differences might arise. This contradicts the main objective of Basel of establishing a level playing field and is considered a very serious drawback. Moreover, the valuation based boundary would lead to an inadequate dependence on accounting standards, which are based on other objectives and motives than those of this prudential framework.
- Fair valued financial instruments do not necessarily imply market risk that affect the solvency of banks. It depends on chosen business-model and some financial instruments might be treated as trading positions even though they are not.
  For example, the Danish mortgage system gives rise to instruments that could be treated as trading positions in case the valuation based boundary is applied. By acting as an intermediate between borrowers and bond investors, the bank only bears the credit risk while the mortgage borrowers and bond investors bear the market risk. But, the assets (loans) are non-traded financial instruments that are fair valued to ensure accounting consistency with the liabilities (the bonds) that are fair-valued instruments. In general, EACB suggests that, in addition to documented hedges, financial instruments that can be demonstrated not to involve any market risk for the bank should be excluded from the trading book.

- Valuation based boundary will have consequences on market risk in the banking book. This may not be appropriate for some risks (e.g. interest rate risk in the banking book- IRRBB). An acceptable uniform standard model that could be the basis for a regulatory measurement of IRRBB, does not exist yet.

However, in case the valuation boundary is finally decided upon, even if all things above are considered, it should be permitted to exclude fair valued financial instruments from the trading book if market price changes on these instruments do not impact the solvency of banks.

Q02:
What are commenter's' views on the likely operational constraints with the Committee's proposed approach to capturing market liquidity risk including the endogenous component and how might these be best overcome?

EACB supports the goal of the committee, to consider market liquidity in the assessment of risk calling into question the current central assumption, that trading book positions can either be hedged or liquidated within a 10-day holding period.

However, the liquidity horizons are rather challenging and hard to model especially in stress conditions. They should rather be modelled internally by product group. A benefit of this approach is that it decreases herding behaviour and helps to increase the understanding of the risks a bank runs. In case of less sophisticated banks, regulators in co-operation with industry should develop standard liquidity horizons by product group.

In general clearer methodological guidance is needed that will ensure the framework for incorporating market illiquidity will be consistently applied across the industry.

There are a number of problems we see with the suggested liquidity elements:

1. ***Using liquidity horizons assigned to risk factors***

This approach implies an objective classification of the various financial instruments to different liquidity horizons. This is achieved by initially mapping the instrument to risk factors and risk factors to liquidity horizons. EACB questions whether this is feasible. Risk factor level is difficult to implement so we rather favour an assessment at the level of financial instruments or classes of financial instruments.

The implementation seems to be costly and complex due to the different liquidity horizons. While we appreciate the Basel Committee intention to provide for more granularity for an increased risk sensitivity, EACB is more concerned about the complexities the framework

entails. EACB proposes to have a reduced number of liquidity horizons for less sophisticated banks. Moreover, a liquidity horizon up to 1 year is in contradiction to the short term nature of trading book positions.

2. Capital add-ons for the potential for jumps in liquidity premia

Additional add-ons for jumps in liquidity premia imply operational complexities and methodological difficulties to incorporate these jumps in the internal models. As acknowledged in the consultative document in section 3.3.2 *(2)* on page 23, there is the potential that market liquidity risks are accounted for on several occasions. Liquidity premia might already be reflected in historical price data used to calibrate the market risk metric. We appreciate the approach described in annex 4 to avoid double counting. However, an easier and better approach would be if liquidity premia are treated through a Pillar II approach rather than modelled. Another way is to adjust the liquidity horizons to be more conservative so they also reflect the liquidity jumps

3. Accounting for endogenous liquidity risk

Further extending the liquidity horizons to incorporate endogenous liquidity increases the complexity of the framework. The endogenous liquidity risk should rather be incorporated through prudent valuation adjustments. The effect that large portfolios might have on the market and other factors relating to banks' own portfolios should be accounted for by adjusting the valuation of the portfolio for regulatory capital purposes – a Pillar II approach.

Q03:
What are commenter's' views on the proposed regime to strengthen the relationship between the standardised and internal models-based approaches?

In principle we welcome the Basel Committee proposal to have a standardised approach (SA) and internal model approach (IMM) more related to each other. This should be done, especially through a better risk assessment for the SA of hedging and diversification effects and less by a restriction these effects in the IMM case.

Mandatory Standardized Measurement and Standardised Approach as a Fall-back

We are concerned that the introduction of the mandatory SA calculation requirement and the use of SA as a back-up for internal models. Banks should only have to calculate the SA for the trading desks not allowed to use the IMM. The obligation to calculate the SA in addition to the internal models for all trading desks can lead to extensive system requirements. This requirement might also lead to losing focus on the internal models as the incentive to maintain and improve internal models will be reduced. Moreover, difficulties

might arise due to reduced availability of valuable time and resources. There should be no forced parallel calculation by using SA or at the very least it should be made more practical by calculating the SA only on reporting dates.

Standardised Approach as a Floor

Having a SA as a floor (or surcharge) in relation to the model based approach would be a new dimension in addition to the Basel I floor (relating to the rapport between Basel I and Basel II) and could also be a disincentive to use and develop an internal model. It will disable effective risk management and proper decision making, especially if the standardised approach would be set conservatively.

Standardised Approach as a Benchmark

While we appreciate the Basel Committee intention to achieve a more level playing field, the SA can hardly be used as a benchmark because products vary significantly across different countries. Moreover, there could be instruments that are not always reflected in the standardised approach.

We understand the Basel Committee objective to motivate a less risky profile for banks, especially in light of the developments that took place in the financial industry during the crisis. Nevertheless, a too conservative approach also limits the bank's ability to provide financial services to business and other clients. Capital add-ons could be used by competent authorities as a pillar II measure in case the internal models are considered not to completely reflect the risk of a bank at a certain moment in time.

Q04:
What are commenter's' views on the Committee's proposed desk-level approach to achieve a more granular model approval process, including the implementation of this approach for banking book risk positions? Are there alternative classifications that might deliver the same objective?

EACB welcomes the idea of a "desk approach". This will make it possible to avoid losing the approval for a model due to a few desks. The increased granularity increases the flexibility of the model and options banks can use to model the market risk. However, we believe that the framework should go one step further: there should be more flexibity for banks to switch off parts of the internal model if the business model changes.

There is a need for a proper definition of desks taking into consideration that the lower the level of supervisory desks is located, the greater the risk that it will not be possible to cover instruments and the related hedges in the same desk.

With regard to the organization of the trading desks EACB supports the idea of following the bank's internal functional organization structure. However, the requirement for a business strategy for each trading desk that supports this structure seems excessive. There are currently requirements on tradable instruments and appropriate limits, on which trading strategies are based, and within which the traders can move freely. We believe that these existing requirements would be sufficient to support the trading structure.

Q05:
What are commenter's' views on the merits of the "direct" and "indirect" approaches to deliver the Committee's objectives of calibrating the framework to a period of significant financial stress?

EACB welcomes that in the future there will not be two different models (calibrated to normal times and calibrated to a stress period) used for regulatory purposes. We acknowledge that stress calibration of the models reduces pro-cyclicality. Nevertheless, stress calibration also leads to a lower predictive power for the models.

Risk measures like VaR and ES calibrated to normal times are used for day-to-day trading. The method of calculation of supervisory capital and risk measures should be more aligned with the business practises. EACB proposes that the models should be calibrated to the current market conditions and then scaled up to a period of significant financial stress to avoid constructing yet another measure that is not used for risk management purposes.

With regard to the methodology of calibration the regulators should allow both methodologies – direct and indirect. Each institution could make a reasonable decision taking into consideration their expertise and needs.

Q06:
What are commenter's' views on the merits of the desk-based and risk-factor based aggregation mechanisms to deliver the Committee's objectives of constraining diversification benefits?

-

Q07:
How can regulators ensure robust supervision of integrated market and credit risk modelling? In particular, how would an integrated modelling approach affect other elements of the proposed framework (e.g. the choice of the quintile parameter for ES, the P&L attribution and back-testing processes, etc)?

We acknowledge that an integrated market and credit risk model could bring benefits regarding the double-counting of the risks problem. Moreover, in case the model does not limit the diversification opportunities between risk classes it could also bring an important incentive for developing such a model. However, constructing such a model would be conceptually challenging. The question is also whether the institutions are willing and able to bear the extremely high implementation costs of an integrated approach. In principle we suggest allowing the use of both integrated and separated models taking into consideration that:

- the suitability of the prudential model depends to a large degree on a practicable validation. A separated model would also make it easier to carry out the ES backtesting;
- at 99% quantile on average 2-3 outliers per year can be expected. The appearance of a single outlier in case of ES can alter the results significantly. We advocate as a quantile basis for the ES to be the 95% or 90% quantile instead of the 99% quantile. The separated model makes it easier to use a lower quantiles for backtesting.

Q08:
What are the likely operational constraints with moving from VaR to ES, including any challenges in delivering robust back-testing, and how might these be best overcome?

The EACB members have different views with regard to the advantages of the new framework. So we do not wish to comment on this. However we would like to make the following remarks.

The current model works well for plain vanilla instruments and, as a consequence, some co-operative banks did not have problems with the model, not even during the crisis. Moreover, first investigations show that the ES is generally a fixed multiple of the VaR in the case of portfolios held by these banks.

With regard to the tail risk, the adequate modelling of the loss distribution itself is highly relevant. Such a modelling was done for VaR through internal models. The fat-tail distributions used in VaR includes information about the “tail” of the distribution.

There are a number of problems and difficulties identified with switching to ES as a risk measure:

- There is a lack of (published) debate on the concept of back-testing of the ES parameter. Currently, it is thus not clear how the ES can be back-tested and how to determine the consequences from the back test, making it hard to validate the model. This remains an unsolved policy issue.

- ES has high outlier sensitivity. At 99% quantile on average 2-3 outliers per year can be expected. The appearance of a single outlier in case of ES can alter the results significantly. Due to the outlier problem, we advocate as a quantile basis for the ES to be the 95% or 90% quantile instead of the 99% quantile.

- The ES does not have robust statistics. Coupled with the problem of outlier sensitivity this could result in significant data quality problems.

- ES does not necessary incentivize dealers as suggested by the consultation paper. It is the task of the bank's internal risk-management and control to always be aware of what the dangers are and to analyze specific positions dealers. This issue can hardly be managed by a choice of risk measure.

- ES may require substantial changes to the internal systems

- If ES would be introduced for market risks there would be inconsistencies relating to aggregation with other risks within the scope of Pillar II/ICAAP.

In case the Basel Committee decides to adopt the ES risk measure as a basis for the market risk models it should be acknowledged that this would be a fundamental change. Its introduction as a requirement would need a longer period of time, a monitoring phase to follow how it is evolving. Also the methodology should be made as practical as possible. For banks using historical simulation, a relatively small number of tail scenarios are available. Banks could and should be allowed to keep the current methodology and current system set-up by setting the lower confidence level of ES to 95% (instead of the 99% quantile). This could be beneficial for the problem of high sensitivity to outliers as well as previously mentioned. In addition, if banks would be required to move away from historical simulation and/or add more complex features to the models, systems will require substantial changes. The investments would be disproportionate to the added value achieved by moving to ES.

Q09:
Which of the two approaches better meets the Committee's objectives for a revised standardised approach?

Q10:
Does commenter propose any amendments to these approaches?

EACB understands the Basel Committee intention to move towards a more risk sensitive Standardised Approach. However, we fear that it will lead to a greatly increased effort, especially for smaller institutions.

The two proposed methods (the fuller risk factor approach - FRFA and the partial risk factor approach - PRFA) for a revised standard method differ significantly in their degree of complexity and its sensitivity to risk. Both, however, seem rather aimed at larger banks, which already have a comprehensive risk management available. Both seem to be a simplified version of an internal model. The FRFA in particular is similar to a small internal model from point of view of complexity and effort of implementation.

The proposed methods do not fulfil requirements for a transparent and simple system suggested by the consultative paper on page 41. The comparability of the trading book of different banks is limmited by the lack of clearness of the proposed methodologies. We suggest to use more simple measures (BPV, Deltas, Gammas) per asset category for compareing different sizes of trading books.

Highly risk-sensitive standardized method will lead to an increased effort, especially for smaller institutions. Even for institutions with an approved internal model both approaches would lead to massive expenses due to their complexity, in case the requirement to use both the internal model and SA is decided upon.

A majority of EACB members favours PRFA because of its relative simplicity as compared to the FRFA while others still have strong reservations. We note that the principle of buckets in the PRFA seems to be rather similar to the existing risk categories in the current framework. What is new is the additional correlations between risk categories or buckets leading to a more sophisticated own funds calculation. We question if this justifies the significant investment the banks have to make in order to implement the new approach.

Generally speaking, is essential that a less complex approach is foreseen for smaller institutions with lower trading activities. The criteria of determining which banks have to use the simpler approach should be based on the size and complexity of the trading activities (proportionality principle).

In case any of the proposals is implemented, EACB members draw attention a number of additional difficulties and aspects with the proposed approaches:

- It is essential that the parameters proposed by regulators are subject to an ongoing supervisory review.
- There is the need for annual adjustment of minimum requirements in order to consider newly developed financial products in a timely way.
- There is the need for clarification on how the parameters for PRFA (risk weights and correlations) in the formula for calculating the capital requirement of a bucket should be set – for each instrument or as flat rate on classes of instruments.
- Even though the two standard models of market risk are more risks sensitive than before, they are far from being adequate for internal control. This means that institutions must carry out a separate risk assessment for risk management and also for purposes of internal risk-bearing capacity.