



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

EACB Comments
on the Consultative Document of the Basel Committee
on Banking Supervision

Fundamental review of the trading book:
outstanding issues

Brussels, 19th February 2015

The voice of 3.700 local and retail banks, 56 million members, 215 million customers

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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 3.700 locally operating banks and 71.000 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 215 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 56 million members and 850.000 employees and have a total average market share of about 20%.

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General Remarks

The members of the EACB welcome the opportunity to comment on the BCBS review of the trading book.

All in all, we see that the suggestion imply a considerable step up in complexity regarding risk measurement models and connected validation methods. The revised requirements will therefore lead to a significant increase in the implementing cost burden for institutions.

In particular, the implementation of the suggested requirements for internal as well as standard models will lead to significant increase of the required human resources (validation, modelling, risk managers, auditors) and of the IT facilities.

We feel that the revised framework is very much calibrated only for big banks with significant trading activities. We fear that the proposed approach is likely to have negative impacts on the business model of a universal bank with a small customer driven trading book.

Thus, we would rather suggest a tiered approach to cover the various business models and keep the complexity and costs reduced for small and medium sized banks and business models with no or very limited trading activity:

- If there is no proprietary trading activity, banks should be able to maintain the existing possibility to have one banking book only;
- In case of a residual/very limited trading activity the existing small trading book framework should be maintained;
- Banks with a non significant trading activity may keep the existing standardised model (i.e. simplified approach);
- Banks with a relevant trading activity should apply the revised standardised model/fallback for internal models;
- Institutions with large/complex trading activity should be subject to the revised internal model;



1. Internal risk transfers between the banking book and the trading book

We welcome the approach of the Committee to invite input on two possible options for the treatment of internal risk transfers (IRTs).

In our view, the treatment proposed under the "Option 1" would present some important drawbacks, as it would force ALM Treasury departments to mitigate all their IRRBB with external counterparts, decreasing banks' ability to benefit from natural diversification effects and increasing its counterparty risk and the related liquidity requirement (through variation and initial margins). Such factors would clearly have negative impacts on the IRRBB mitigation strategy and are highly cost ineffective.

We regard with more favour "Option 2", which would give the banks greater benefits in managing the IR risk towards the banking book. This option would make it possible to internally hedge individual banking book exposures with the trading operations and to externalise on the market only for larger exposures, with a clear cost advantage.

Nevertheless, even under "Option 2" there are some aspects which may have detrimental impacts on the management of risk.

In particular, we see as unnecessary and hard to understand the requirement for which the IRTs and external hedges of those transfers cannot be used to offset interest rate risk arising from trading book activities, and should be aggregated under a distinct trading book. Such requirement would in fact lead to two trading books in one entity, where the economical risk on one market would be significantly different from the regulatory capital requirements, not allowing the offsetting from positions of the same risk factors. We believe that such point should be disregarded.

In addition, the new regulatory IRT transfer possibility shall have to be reflected in the IFRS regulation as well.

2. The revised standardised approach for market risk

Regulatory reporting requirements demanded by the standardised approach are very high, and the same information has to be reported multiple times. Moreover, the current requirements would put the authorities in the position to calculate all of the required data.

In order to minimise implementation costs, it should be assessed whether the capital figures for the simplified/standard model could be calculated by the regulator itself or whether a standard IT solution could be provided for the institutions.

This would have the advantage to decrease implementation costs for the whole banking system and increase comparability of data across all jurisdictions.



We believe that the results of the QIS shall be published before the final calibration is determined. Only then would it in fact be possible to estimate the effects of the revised standardised approach for market risk.

3. Incorporating the risk of market illiquidity in the internal models approach

Aligned approaches

The Committee has already recognized that decisions to introduce liquidity horizons as part of market risk metrics in order to capture the risk of illiquidity will lead to partial overlap with prudent valuation requirements. We believe that this point should be further highlighted.

It is extremely important to avoid the situation when prudent valuation adjustments, which include also illiquidity adjustments, are calculated differently for different portfolios. Moreover, since prudent valuation is based on accounting categories, while the trading book is not linked to trading assets/liabilities explicitly, the differentiation in illiquidity requirements may create unnecessary difficulties and confusions.

The principles behind illiquidity risk treatment under the market risk framework as well as under the prudent valuation requirements should be the same – otherwise, in case of a shift of positions between banking and trading book, indirect capital benefits may materialise.

The treatment of liquidity risk is still seen in different perspectives from a prudent valuation point of view and capital requirements one. For instance, in its final Regulatory Standard on prudent valuation, EBA specifies that valuation adjustment are to be defined with 90% certainty. On the contrary under the revised market risk framework potential losses are measured with 97,5% confidence interval (one should keep in mind that the last is to be defined within expected shortfall framework calibrated under the stress conditions).

We agree with Committee that market liquidity and increase of liquidity spreads is a crucial question for bank solvability, especially in time of market crisis.

We would propose to incorporate a market liquidity capital charge as an incremental capital charge, which can be monitored and managed separately. An incremental capital charge should be designed in a way that it can be easily incorporated into prudent valuation framework.

In addition, banking book exposures accounted at purchase price according to national GAAP might be less affected than trading book exposures where the principle of the lower of cost or market value applies.



Liquidity horizons

The liquidity of a particular position depends from both internal and external factors, namely: liquidity of the market in general, liquidity of a certain issuer and issue, concentration of position in relation to market size; to capture all this nuances in a single framework seems to be an ambitious task. Thus we understand the will of the Committee to simplify the issue via introducing standard liquidity horizons on a level of risk factors.

However we would like to underline that proposed approach seems to be too simple, and a lot of crucial factors influencing market liquidity are left out of scope (e.g. market liquidity or concentration). This may lead to either an overestimation or an underestimation of capital needs. As a minimum solution we would propose to incorporate different currencies/currency pairs into proposed liquidity horizons.

We welcome the 10-day treatment introduced in the previous consultation paper; however, since major FX rates (EUR, USD, GBP) are very liquid, even large positions can be liquidated within minutes. For such FX and IR a yet shorter liquidity horizon would be more realistic (5 days).

4. The balance between simplicity, comparability and risk sensitivity

Overall we see a step up in complexity for risk measurement models and connected validation methods. While we believe that the design of new requirements should avoid raising the implementation costs for banks, the proposed requirements for internal as well as standard models will lead to a need for significant increases in qualified staff (validation, modelling, risk managers, auditors and IT).

In addition, it seems that the revised framework is mainly tailored on big banks with significant trading activity. Instead, we expect a negative impact to the current employed business model of a universal bank with a small customer driven trading book.

Although not mentioned in the current consultation, we would like to refer to small banks which do not exceed certain thresholds of the trading book business.

For instance, according to Art. 94 CRR credit institutions with a trading book business that is normally less than 5 % of the total assets and EUR 15 million, and never exceeding 6 % of the total assets and EUR 20 million, may apply a simplified calculation method for the capital requirement for market risk. They may allocate the market risk to the calculation basis of the credit risk and may calculate the capital requirement according to the provisions for the credit risk.

Only such simplified requirements enable numerous small institutions to take trading activities for their clients, as otherwise they would have to sustain excessive organizational and prudential efforts to fulfil the capital requirements of the trading book.



The new definitions of the boundary between banking book and the trading book should therefore not hamper the possibility of small banks to apply the simplified calculation method for their client's activities.

Moreover, the proposed presumption that listed equity belongs to the trading book can not be true for all cases. The possibility to hold a participation in a listed joint stock company in the banking book must be kept at least for certain cases, for instance where the institution holding this participation has the intention to contribute to its own activities by creating a durable link to that listed company.

In this respect, a four-tier approach could be envisaged to cover the various business models, keep the complexity and costs reduced for small and medium sized banks and for business models with very limited trading activity

- Residual/very small trading activity – keep the existing small trading book regulation
- Small trading activity – keep the existing standard model regulation (rename to simplified approach)
- Normal trading activity – revised standard model/fallback for internal models
- High/complex trading activity – revised internal model

The set of criteria for assignment to the capital methods could encompass the following drivers: P/L of trading activities; organizational structure (# traders, # desks, # markets, # products); open position sizes and trading turnover; complexity of products (digital payoffs, path dependent products require internal model).

5. Other elements on the trading book review

Disclosure platform for risk factor / market data

We observe that it is very difficult and expensive for a bank to get the market data to develop quantitative models for assessment of market liquidity and concentration risks. Transaction level data throughout the markets are usually not easily available to banks.

Regulators/supervisors have broader access to data and would need the data also to understand the current state of financial markets. Therefore we would see it an advantage if the regulator would disclose the appropriate data for banks' usage.

Participations

The current requirement to hold all equities in the trading book is against many banks current practice of having a participation book that is not traded on a trading desk and is not steered on daily prices.

There should be a solution for investment in equities. This should include criteria for the assignment to the trading/banking book.



Revised Internal model approach

Move from VaR to ES

Expected shortfall (ES) is useful measure. However, the inability of VaR to capture tail risk should not be the principal argument in favour of ES – ES is just a different measure; its ability to capture tail risk is not measure-inherent. For ES to capture any tail risk, or to provide a different view on it, the underlying distributions must be correct in the first place. Given the great difficulty in assuming any tail behaviour as defined by distribution choice and parameterization, ES is no better in giving an accurate view on those tails, as they are in fact determined not by the measure, but by the entity (the joint distribution) being measured/estimated.

Stability of ES model not improved in comparison to VaR

ES provides some benefits, however we disagree with the fact that it would deliver "more stable model output" and "less sensitive to extreme outlier observations" - VaR has these properties, as quantile are not greatly affected by extreme tail behavior. ES is likely to be influenced to a non-trivial degree by both outliers and tail distribution assumptions. (Except if the period of returns used for calculation is kept constant in a stressed ES setting.) Nevertheless, we welcome the increased weight given to this additional measure.

General comment on risk metric extensions

Internal models are quite rigid, and tuned to one specific purpose. Alternative and additional risk views are often difficult to natively incorporate into the VaR/ES framework. For example, extreme events, or liquidity issues are conceptually (e.g., outliers don't affect VaR) or numerically (e.g., longer simulation periods with various additional assumptions) not well-suited to the scope of a typical return distribution estimation. Whenever possible, such separate risk assessments should be made possible by specific stress tests - they are easy to define consistently, and can be calculated consistently within the overall distribution approach. (Also applies to the artificial restriction of market observed diversification effects.)

P&L attribution / Backtesting

Since the original treatment in the revised market risk framework has not been developed further in the new consultative document, one of the main open questions is if the economic backtesting procedure shall follow the accounting P&L or the FO P&L scheme. Either has advantages and disadvantages. The FO P&L is daily available on a granular level required for the P&L attribution comparison where the accounting P&L is not available on daily basis in most of the small to medium sized banks.

With regard to "P&L attribution requirements" it is unclear whether "mean of difference" should be "mean of abs(difference)", and whether standard deviations should be used instead of dimension-wise less expressive variances.



Organizational separation of validation and model development

The strict separation between modellers and validators under Annex 1, D, 2, (c), "A distinct unit must conduct the initial and ongoing validation of all internal models" is a very cost-intensive and possibly prohibitive requirement.

We propose that the regulator provides a set of criteria when a full independent validation team has to be established. For medium sized banks this is a criteria will certainly withhold the bank from going into internal models.

Calculation of FX-sensitivity in the standardised approach

Assuming that the exchange rate is quoted in FOR/DOM, the formula should be independent from the absolute level of the exchange rate, thus the FX_k in the denominator seems superfluous. The raw FX-spot delta gives the sensitivity in the foreign currency. Taking the FX_k out of the denominator gives s_{ik} in the reporting currency (reverse delta).