



EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS
The Co-operative difference : Sustainability, Proximity, Governance

EACB Comments

DG FISMA Consultation Document

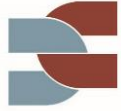
PROPORTIONALITY IN THE FUTURE MARKET RISK CAPITAL REQUIREMENTS AND THE REVIEW OF THE ORIGINAL EXPOSURE METHOD

Brussels, 24th June 2016

The voice of 4.200 local and retail banks, 78 million members, 205 million customers

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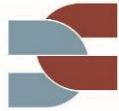
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The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks 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 4.200 locally operating banks and 68.000 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 205 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 78 million members and 860.000 employees and have a total average market share of about 20%.

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Introduction

The members of the EACB appreciate the Commission's initiative for a consultation on proportionality aspects linked to implementation of future market risk capital requirements and the review of the original exposure method.

Like no other standard of the BCBS, the substance of the "Fundamental Review of the Trading Book" is targeting large international banks, where market risk has importance and dimension. Today the overwhelming majority of small cooperative banks does not have a trading book, since the dimension of market risk in the context of their business model is not relevant and thus does not require it. We also do not know of any evidence about deficits regarding the management of market risk in smaller cooperative banks, which would make the introduction of trading books in smaller institutions advisable. The introduction of a trading book as designed according to the new Basel standard would go beyond the capacities of smaller institutions and even be completely inappropriate from a cost perspective

We thus welcome the opportunity to comment on this DG FISMA consultation on the application of proportionality in. The final outcome should be proportionate solutions, which are both simple and pragmatic.

Answers to specific questions

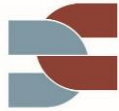
Q.1 Can the new standardised approach in the BCBS FRTB framework be easily applied to all institutions with a trading book? If not, which elements of this approach would be more challenging to implement and for which types of trading books? If possible, please provide a quantification of potential implementation costs for the institution concerned.

The Fundamental Review of the Trading Book (FRTB) introduces some new concepts to the standardised approach (e.g. use of sensitivities), which are complex and entail a challenging implementation. Building new models, implementing new frameworks and applying new concepts are burdensome and resource-consuming tasks.

In addition, the granularity of data that is required by the FRTB approach is noticeably higher than under the current approach of Art 360 CRR. Hence, apart from implementing the new methodology of calculating the own funds requirements, banks would also have to adapt and considerably expand their data basis. One Member reported that the cost for a bank would be at least € 1 million, which is a very considerable investment for an institution with small trading book activities.

Institutions without a trading book or with a small trading book are executing derivative transactions only for the hedging of their ordinary banking book business. Any models requiring high data (e.g. daily market prices) would require a very demanding implementation and high cost.

In our opinion, the market risk model for small trading books (beyond the thresholds in Art. 94 CRR) in the current CRR should be maintained (instead of the standardized approach), due to its reduced administrative burden and limited regulatory cost. As a



second-best alternative, we could imagine the introduction of a standardized approach which is more simple than the one of the FRTB (see below under Q 2)

Q.2 In case the new BCBS standardised approach from Basel is not considered an adequate framework for all institutions with a trading book, which of the following three alternatives would be considered the most appropriate framework to deal with smaller or simpler trading books and why?

a. The current treatment under the derogation for small trading books with increased thresholds and potentially the necessary clarifications and reviews described above;

b. a simpler standardised approach;

c. a combination of the former two elements with potentially two different thresholds.

Please, also specify, for the alternative chosen, which considerations have to be taken into account to re-calibrate the level of the threshold(s) and the appropriate calibration of the threshold(s).

With regard to the potentially extended scope of instruments to be assigned to the trading book (equity investments in a fund, listed equities) under the FRTB, but also with regard to the classification of certain shares as Level 2B assets under the LCR, we see an urgent need to maintain the current treatment (exemption) with minor updates for the smallest institutions. The FRTB standardized approach would not be proportionate for banks with small trading books, and implementation costs would be much higher than long term profits from small trading book activities. Aspects of the FRTB approach that would result in high implementation cost are e.g. the fact that sensitivities would have to be calculated. This would affect also FX and commodity risks as these are not covered by the threshold for small trading books.

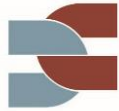
For institutions beyond those thresholds we suggest to maintain the market risk model of the current CRR (instead of the standardized approach), due to its reduced administrative burden and limited regulatory cost. As a second-best alternative, we could imagine the introduction of a standardized approach which is to be simpler than the one of the FRTB (see below under Q.2). In fact, we believe that the extensive granularity of the BCBS standard poses too high costs. A suitable model for such a simplified version of the FRTB would be the simplified sensitivity-based method that has been developed by collaborators of the German BaFin (see annex).

Q.3 In case option b) or c) have been chosen, which of these two possibilities would be considered the most appropriate regime for institutions with smaller or simpler trading books;

a. a simplified version of the new standardised approach, to be developed; or

b. the current standardised approach?

Please, justify your answer from a cost-benefit perspective. If a) is chosen, please specify which simplifications to the FRTB standardised approach would need to be performed.



As mentioned above, we believe that the extensive granularity of the BCBS standard poses too high costs and therefore suggest to maintain the market risk model or, as a second-best solution, a simplified standardized approach.

Q.4 Please, indicate which of the two conditions provided in Article 94 of the CRR is currently more constraining for your institution, supporting your answer with data reflecting the evolution of total trading exposures in balance sheet.

The existing thresholds are a crucial element for institutions to benefit from the small trading book derogation according to Art 94 CRR. The absolute amount may in general be considered more constraining. Against this background we believe that a readjustment of the existing thresholds is long overdue and inevitable as they have not been adapted for years. This is even more so required, since more and more products tend to be assigned to the trading book.

As a first suggestion we would recommend updating the absolute threshold to take into account at least the effect of inflation over time. As the current limits were fixed in Article 4(6) Council Directive 93/6/EEC back in 1993, we consider a yearly 2% rate up to 2016. 2% would be consistent with the inflation target of most Central Banks and also with data from Eurostat (1.7% considering the HCPI for the Euro area¹).

The 15mn "normal" minimum should thus be brought to 23 and the 20mn threshold to 32 million ad minima².

In addition, we propose to extend the scope of the derogations under Article 94. In order to achieve a more proportionate application of the trading book rules, the exemption of Article 94 (1) CRR should not only have Article 92 (3) (b) CRR in scope, but rather comprise also the entire trading book rules of Articles 102 to 106 CRR. These rules pose an excessive administrative burden to institutions with small and very small trading books while delivering only marginal additional value.

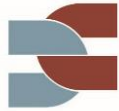
Moreover, for small positions in FX and commodities that are not held for any of the purposes of para 12 of the BCBS market risk standard³ an additional threshold should be implemented. FX and commodity positions that do not exceed this additional threshold should be exempted from capital requirements for market risk.

A further aspect that needs to be considered for a proportionate implementation of the FRTB relates to the reallocation of instruments to the trading book. If the supervisors require such reallocations, given the expanded scope of instruments to be assigned to the trading book, such reallocation could trigger the requirement to introduce a trading book in certain institutions. However, supervisors should not assume that institutions already manage a trading book. Most small or less complex cooperative banks do not have a trading book. Adequate transitional periods should be granted to institutions,

¹ <https://www.ecb.europa.eu/stats/prices/hicp/html/inflation.en.html>

² 15 or 20*(1+0.02%)²³

³ BCBS 352



where following a request of the supervisor the establishment of a trading book would become necessary.

Q.5 Besides the level of the thresholds, do you agree with the previous analysis on the other elements of the derogation for small trading book business? Which ones would need to be addressed and how?

a. The definition of the thresholds, making them more specific and harmonized as described above

b. the clarifications on the application of the credit risk framework to some trading exposures, especially derivatives; and/or

In the case of item b) please specify which clarifications/modifications would be necessary and for which trading exposures in particular. In the case of changes to a) and b), please provide some measures of quantitative impact of the modifications proposed on your institutions.

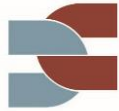
The above mentioned threshold levels are closely related to the scope of the trading book, i.e. the transactions and instruments assigned to it . In this respect, also with regard to aspects of proportionality, the following issues have to be taken into account:

Nature of Trading (customer related transactions): Often trading transactions are conducted by the institute on the customer's account. Thus in connection with these transactions there is no market risk or default risk for the bank. Thus, we do not see any trading purpose when an instrument is merely bought or sold by institutions in the execution of an order of a customer. In this case the bank merely acts as service provider - typically in form of a commissioner – on behalf of the customer and on his/her account. Economically, these kinds of transactions are not creating any market or default position risk position for institutions since the customer shall be the owner of the traded instrument. This approach is in line with para. 12 of the BCBS FRTB, which contains a list of purposes for an instrument held by a bank to be designated as a trading book instrument ((a) short-term resale; (b) profiting from short-term price movements; (c) locking in arbitrage profits; (d) hedging risks that arise from instruments) meeting criteria (a), (b) or (c)).

For this reason the following banking transactions should be out of scope of the trading book:

- Client's business in funds and certificates;
- Client's business in OTC-derivatives (simple sale and resale transactions);
- Client's business in bonds and other securities;
- Client's business in FX;
- Client's business in commodities.

"Listed equities" as trading book instruments (para. 16(d) BCBS FRTB)



According to para 16(d) "listed equities" are trading book instruments. However, not all listed equities are held with trading intent respectively for one or more of the purposes defined by para 12 of the FRTB. Thus, we believe that deviations, as foreseen under para 17 have to be foreseen:

- a) Equity instruments, which qualify als 2B Assets under the LCR and which are held for liquidity purposes should not be treated as tradable instruments.
- b) Other equity instruments may be held with "participating interest". "Participating interest" (Art. 17 Accounting directive 78/660/EEC) implies the holding of rights in the capital of other undertakings, whether or not represented by certificates, which, by creating a durable link with those undertakings, are intended to contribute to the company's activities.

Moreover, institutions being associated to a central body would be extremely affected by schematically assigning listed equities to the trading book. The central institution could be listed, whilst the members of the cooperative community are holding their equities certainly without any trading intent. Indeed, they are just part of the cooperative community being associated to a central institution. Consequently, there should be an explicit exclusion for listed equities arising from an association to a listed central institution.

Especially in the case of smaller institutions, future EU rules for small banks on the allocation of equity instruments to the trading book or banking book might be influenced by revised capital requirements for equity instruments.

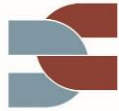
Instruments held for other purposes than trading

A highly relevant issue under within the context of proportionality would also be "equity investments in a fund" (para. 15(e), 16(c)BCBS FRTB). According to para 15(e) of the FRTB "Equity instruments in a fund, including but not limited to hedge funds, in which the bank cannot look through the fund daily or where the bank cannot obtain daily real prices for its equity investment in the fund" must be assigned to the banking book, while those, which do not meet both of these conditions would be assigned to the trading-book.

According to para 17 banks can request permission from the supervisor to assign those assets to the banking book.

Moreover, we see the need to differentiate more specifically among funds those that are to be assigned to the trading book and those that are not. This could be done taking into account their trading purposes, the investment strategies, exposure to particular risks as well as the powers of the banks to influence investment decisions.

However, the requirement in para. 17 of the BCBS standard on market risk to submit a request to the supervisor in order to deviate from the presumptive list established in para 16 is very burdensome. Not only the thereto connected massive administrative work load, but also the disproportionate uncertainty while awaiting the official decision (approval or prohibition) by the supervisor are stressing and hampering the ongoing business of the institution.



The process of supervisory approval that is described in para 17 of the BCBS standard has several disadvantages especially for small banks and thus it is not a proportionate approach. According to para. 17, banks would have to presumptively assign the instruments as of para. 16, including equity investment in funds, to the trading book until they receive the approval of the supervisor for any change. It can reasonably be assumed that a vast amount of cooperative institutions will submit a request for approval to the supervisor. Consequently, it would take months until the institutions receive feedback from the supervisor, either as approval or denial. In the meantime, banks would have to fulfill all trading book regulations for their para. 16 instruments if they exceed the thresholds (cf. Q.4). This would also include designing and implementing a system for calculating Additional Valuation Adjustments according to Commission Delegated Regulation 2016/101⁴. After the approval of the supervisor for deviation from the presumptive list, such a system would become superfluous. In our opinion, the process of para. 17 poses an unjustifiable and unnecessary administrative burden and cost for institutions with small trading books.

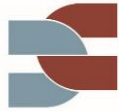
As the majority of small cooperative institutions that have equity investments in funds are holding these for strategic reasons and, hence, do not fulfill any of the purposes listed in para 12, we propose the following approach that we regard to be proportionate even for small banks: Equity investments in funds and all other instruments mentioned in para. 16 should be assessed by the institution itself (e.g. based on historic transactions) regarding whether any of the purposes of para 12 does apply to them, or whether those instruments are held for other purposes (e.g. requirements of the LCR or strategic reasons). According to the result of this assessment the bank must decide whether those instruments are allocated to the trading book or the banking book. The result of this assessment would then be sent to the supervisor for information rather than for approval.

Q.6 For those institutions that currently use the OEM, do you see any merits in replacing the OEM with the SA-CCR in the prudential framework? Would the operational difficulty to implement SA-CCR be the only impediment for your institution to the replacement of OEM by SA-CCR? Would your derivative activities be negatively impacted by the introduction of SA-CCR due to the impact of the replacement of OEM by SA-CCR on the risk-based capital requirements and leverage ratio requirement?

The use of daily market prices under the SA-CCR would show a more correct risk exposure than under the OEM. However, the technical implementation and cost, particularly due to daily data availability, would be considerable, so that the SA-CCR seems only appropriate for banks of a certain size. We therefore recommend to maintain the OEM for certain institutions and to align the scope of application of the OEM to the one under Art. 94 CRR

Beyond those thresholds, we would prefer a simplified SA.

⁴ i.e. the regulatory technical standard for prudent valuation under Article 105(14) CRR



Q.7 For those institutions that see no merits in replacing the OEM with the SA-CCR, do you find it appropriate to keep the OEM in its current form, including its link to the derogation for small trading book business, its specific use for the calculating the leverage ratio and the CVA charge? If not, please explain what you would like to change in the current application of the OEM under the CRR and why. In addition, would you find it relevant to develop some limited modifications to the OEM to ensure that it is more consistent with the SA-CCR (while avoiding undue increases to the complexity of the OEM)? If yes, which modifications would you propose to the OEM to be more consistent with SA-CCR?

We believe that the OEM in its current form, including its link to the derogation for small trading book business, its specific use for the calculation of the leverage ratio and the CVA charge is appropriate for institutions with small or no trading book business.

Q.8 For those institutions that currently use either the MtM Method or the SM, do you see any merits in replacing these approaches with the SA-CCR in the prudential framework? Would the operational difficulty to implement SA-CCR be the only impediment for your institution to the replacement of these approaches by SA-CCR? Would your derivative activities be negatively impacted by the introduction of SA-CCR due to the impact of the replacement of these approaches by SA-CCR on the risk-based capital requirements and leverage ratio requirement?

The introduction of SA-CCR would tie resources from other projects and thus increase cost or slow down other highly relevant projects. We do not see any apparent benefits of SA-CCR for smaller banks, neither from the perspective of banks nor from the supervisory perspective. The SA-CCR is a far more complex approach than the current MtM method or SM. Hence, a sound proportionate approach to counterparty credit risk should maintain the MtM and SM in their current form and application. This would allow small and regional banks to keep regulatory cost at a reasonable level. Larger banks, however, who prefer a more complex and risk-sensitive approach, should be able to use the SA-CCR.