



European Banking Industry Committee

European Banking Federation (EBF) • European Savings Banks Group (ESBG) • European Association of Cooperative Banks (EACB)
European Mortgage Federation (EMF) • European Federation of Building Societies (EFBS)
European Federation of Finance House Associations (Eurofinas)/European Federation of Leasing Company Associations (Leaseurope)
European Association of Public Banks (EAPB)

20 October 2008

EBIC RESPONSE TO THE EUROPEAN COMMISSION'S WORKING DOCUMENT ON POSSIBLE CHANGES TO THE TRADING BOOK CAPITAL REQUIREMENTS

The European Banking Industry Committee brings together European banking associations with a mandate to provide advice, assure a comprehensive consultation of market participants and ensure a representative industry view throughout the process of drafting, adopting, implementing and enforcing EU-financial legislation and thereby provide input for the European institutions and their relevant sectoral committees. It is amongst the declared aims of EBIC to advise the Commission on relevant legislative banking and cross-sectoral initiatives and any developments at Community level affecting the banking and financial services activities associated with the establishment of a European Single Market for financial services.

EBIC has been established by the main banking industry federations: the European Banking Federation (FBE), the European Savings Banks Group (ESBG), the European Association of Cooperative banks (EACB), the European Mortgage Federation (EMF), the European Federation of Building Societies (EFBS), the European Federation of Finance House Associations (Eurofinas) / the European Federation of Leasing Company Associations (Leaseurope), and the European Association of Public Banks (EAPB).

1. General remarks

EBiC very much welcomes the opportunity to comment on the European Commission's working document envisaging possible changes to capital requirements for the trading book. EBiC would like to underline once again the importance of a constant and substantial dialogue between regulators and the industry, especially as regards the devise of responses to the current events in the market place. In this context we would like to point to the extensive efforts the industry is currently undertaking to improve risk management procedures and the need to coordinate regulatory initiatives with such efforts.

EBiC notes that the Commission's proposal follows closely the developments at international level, notably the two consultation papers released by the Basel Committee on 22 July 2008. EBiC very much welcomes concerted action at international level and stresses the importance of establishing a global regulatory level-playing field.

EBiC agrees with many of the perceived weaknesses identified by the Basel Committee and the Commission in relation to the trading book and therefore understands the willingness of regulators to adopt measures that would address such shortcomings. EBiC also concurs as to the observation that the proposed incremental risk charge (IRC) goes well beyond the current state of risk modelling at most banks, for which reason its implementation will require considerable efforts by the industry.

It is important to highlight that regulatory requirements need to be commensurate with the risks identified at each individual firm. The principle of proportionality should equally apply to trading book issues and ensure that the effort of modelling and measuring risks is adapted to the level of complexity of the business and the materiality of the positions. From this perspective it is observed that the proposals put forward by the Basel Committee and the European Commission seem to focus on sophisticated investment banks and neglect retail banks for which the trading book represents only one of their sources of revenues. The approach put forward will complicate much more the calculation of capital charges with internal models and is most probably likely to discourage the very introduction of internal models for specific risks. Furthermore, neglecting the principle of proportionality risks to result in inflexible regulatory model specifications, which are primarily of a conservative nature and which will make actual advantages of internal models irrelevant.

2. Specific comments

i) Principles based approach vs. legal certainty

Commission services enquiry: The Basel Committee's consultative paper and the possible CRD changes reflect broad regulatory principles. They would leave institutions and supervisory authorities a degree of latitude in respect of implementation. At the same time, and when compared to other areas of capital requirements, the text may be considered to offer institutions relatively limited guidance for the implementation of the capital calculations. This could raise concerns about the legal certainty offered. Additional and more detailed guidance could be offered – if desirable – either as part of the Directive or in (legally non-binding) guidelines to be prepared by the Committee of European Banking Supervisors CEBS.

Stakeholders are requested to express any views as to whether more detailed guidance is desirable, in which areas, and in which legal format: Directive text or CEBS guidelines?

There is general agreement among EBIC members that the Basel Committee's consultative guidelines offer institutions relatively limited guidance for the implementation of capital calculations. In some areas, such as the definition of "default-free interest rate instruments" or "re-securitisations", the proposed approach contains rather crude and unclear rules for which it would be desirable to have more specifications.

It is important that the international level-playing field be insured and distortions of competition to the detriment of European banks avoided. Therefore any additional European specification should not go beyond the regulatory thrust of the Basel Committee's consultative documents. In order to ensure within the EU that regulatory authorities in different jurisdictions implement the proposed IRC in a homogeneous way and to ensure the comparability of the regulatory capital among different banks it would be desirable to have appropriate guidelines elaborated by the Committee of European Banking Supervisors (CEBS). In the same line of thought, an appropriate "standardized" version of the IRC would be considered desirable, especially for retail banks.

ii) Implementation of the new requirements

Commission services enquiry: The Basel Committee suggests that institutions adopt an approach for all incremental risks from 2011 onwards. During 2010, institutions would need to adopt an approach that covers, but is not limited to, both incremental default and incremental credit migration risks. This gives rise to a timing issue between the EU and any final Basel recommendations. According to the current Article 47 and Annex V of Directive 2006/49/EC, EU-institutions will be required to have an approach in place to capture incremental default risk at latest beginning 2010. Institutions would subsequently need to extend that approach to cover all incremental risks after the changes outlined in this consultation paper are applied. The Commissions services are of the opinion that these changes could apply by beginning 2011, bearing in mind the time needed for the European legislative process and national implementing legislation at Member States' level. As consequence, during 2010, the Basel Committee would expect banks to hold capital for both incremental default and migration risk, while EU-legislation would only require capital for the former type of risk.

Stakeholders are requested to express their views about the impact of this possible temporary deviation.

There is general consent among EBIC Members that the timetable for implementation is too ambitious. In any case, envisaged EU changes could not apply earlier than beginning of 2011 given the time needed for the EU legislative process and for the transposition of EU legislation into the Member States' legal systems.

Furthermore, the proposed calculation of the IRC represents a novelty in the area of risk management and does not even represent a best practice. Not even approximate evaluations have been conducted and effective quantitative impact studies would require first technical uncertainties to be addressed, models to be designed and tested and validation frameworks for back testing to be devised. Given that such comprehensive work still needs to be undertaken and given that the introduction of the IRC may radically change the way in which regulatory capital is calculated for

market risks, EBIC Members argue in favour of a smoother introduction of the IRC and an extended implementation period.

iii) Impact of the new requirement

Commission services enquiry: *The Commissions services are interested in fully understanding and assessing the potential impact of the changes under consideration. Respondents are therefore requested to comment on:*

- *Compliance costs, and*
- *The possible impact on the capital requirements of institutions.*

If possible, stakeholders are asked to supply both quantitative and qualitative information. As far as is possible, this should be differentiated by sub-portfolios, describing their size and composition, and by providing a meaningful description of assumptions and methodologies underlying comments.

EBIC Members agree that the full-scale implementation of the IR modelling standards (development, testing, validation, implementation) will require significant efforts, in particular in terms of data requirements, IT and human resources, which will lead to considerable costs. It is not yet possible to estimate the precise compliance costs, especially as many issues about the implementation of the IRC are still unclear.

In principle it has been assumed that the capital requirements for market risk in the trade book will rise significantly, which is also the intention of regulators. Even solely on the basis of the first consultation paper regarding “Incremental Default Risk”, the regulatory capital for market risk is expected to double or even triple. This factor will increase significantly as a result of the expanded requirements of the revised consultation paper regarding “Incremental Risk”. A more precise quantification does not appear to be possible at this point in time, as the corresponding model still needs to be developed and implemented. At present a QIS does not make sense as the level of sophistication of models does not allow a serious assessment at this time.

Tentative trial calculations revealed that in some cases the capital requirements for trading book positions were even bigger than the banking book (IRB) capital requirements. As the control processes, valuation framework and risk management principles differ for both books, we would like to suggest to cap any capital requirement for trading book positions at the relevant banking book capital requirement.

iv) Scope and coverage

Commission services enquiry: *According to the draft proposals, the approach that would capture incremental risks would reflect all price risks, except those directly attributable to movements in commodity prices, foreign exchange rates, or the term structure of default-free interest rates. This gives rise to certain questions.*

(a) Should there be a list of specific types of events that must be captured (e.g. defaults, migrations, and only certain types of movements in credit spreads and equity prices)? How to determine which types of events should be included and how to avoid a retrospective framework?

(b) Should the scope and coverage be expanded to capture the incremental risks and cover price risks associated with commodity prices, foreign exchange rates and the term structure of default-free interest rates?

The idea of a list containing specific types of events that would have to be captured is interesting. On the one hand such a list would help to make the application of the IRC simpler and more homogeneous across banks. On the other hand, such a list, if too prescriptive, could stifle firms' capacity to adopt an approach that would suit their profile.

The Commission's question on which risks should be most appropriately included in the IRC cannot be answered ex-ante, but could only be decided after a consistent impact study and a more intensive dialogue with financial institutions. In principle, substantiality of a risk should be the main focus. The content of the list should also allow for the individual configuration of a bank's trading portfolio to be considered in an appropriate way. Constant dialogue with the industry and periodical revisions of the list would be needed to ensure that the appropriate event types are chosen and that the overall approach remains forward looking.

As regards the possibility of expanding the scope and coverage of the IRC, a "blanket expansion" of the area of application to the so-called "non-IRC market factors" would contradict the idea of the incremental charge, increase the model's complexity even more and devalue the 10-day VaR.

v) **General versus specific risks**

Commission services enquiry: *Capital requirements would depend in various ways on three types of risks: general market risks and specific risks, as defined under the current MRA, and incremental risks.*

Are the differences between these types of risks clear and measurable?

The difference between these types of risks is not easy to measure. A more precise (more operative) definition of general market and specific risk would help improve understanding. The IRC however has been defined in a way that it overlaps with both general market and specific risk and therefore it raises the issue of double counting.

vi) **Double-counting adjustments**

Commission services enquiry: *While the capital horizons and confidence levels underlying the approach to capture the incremental risks and the 10-day VaR charge would differ, the risk factors captured by these risk measures would overlap to a significant degree. However, any adjustments to offset any such 'double-counting' would complicate the framework and diminish the importance under Pillar 1 of the 10-day VaR calculations, including incentives to estimate the 10-day VaR as accurately as possible.*

The Commission services are interested in receiving views about the possibility of devising double-counting adjustments that would avoid the concerns mentioned above.

There is general agreement among EBIC Members that double counting should be avoided because it is inefficient and distorting. The main concern with double counting is that it is likely to trigger regulatory capital requirements that are disproportionate to the identified risks.

If double counting cannot be avoided, the option of making corrections so as to mitigate its effects must be granted to banks. However, it is anticipated that this type of correction will only be possible

as an approximate adjustment across the board. Both with a fundamental conceptual overlap and also with such “rule of thumb” adjustments, the applicability and acceptance of the IRC will in turn be limited.

vii) Capital horizon and confidence level

Commission services enquiry: An approach to capture the incremental risks is envisaged that incorporates:

- a one-year capital horizon,
- a 99.9% confidence level, and
- a liquidity horizon appropriate for each trading position.

The Commission services understand that such an approach could present significant practical challenges for institutions in particular as regards the need to have data available to calibrate key parameters.

- (a) What alternative arrangements exist that could involve lower costs and avoid implementation challenges that would still achieve the same objectives?*
- (b) Given the current state of risk modelling, is it feasible to estimate the portfolio loss distribution over a one-year capital horizon at a 99.9 percent confidence level?*
- (c) Should institutions be permitted to use a single horizon for all covered positions (e.g. three months) and a lower confidence level (e.g. 99%), together with a supervisory scaling factor, calibrated to achieve broad comparability with the IRB Framework for the banking book? Would such an approach be as useful for internal risk management purposes as the proposed approach to capture the incremental risks?*

a) Alternative arrangements could involve an appropriate calibration of a higher multiplier. This should be based on a widespread quantitative impact study involving all banks that presently use internal models and should pay attention to the needs of different types of banks: investment, as well as universal banks.

b) As regards the feasibility to estimate the portfolio loss distribution over a one-year capital horizon at a 99.9 % confidence level, it is considered that the modeling assumption plays an important role and can impair heavily back-testing, validation and use-test.

The parameters implied in the model are perceived as inadequate. In particular, the one-year capital horizon is seen as being a disproportionately long period of time for traded products. Such a long period is disregarding the dynamics of traded products and is likely to trigger big unbalances between the banking and the trading book, overcharging the latter. Moreover, combined with an unclearly defined constant level of risk assumption, the one-year capital horizon can be considered unrealistic.

In contrast, the given calculation cycle of one week for IRC is considered to be very short. A one-week calculation cycle disproportionately increases internal costs for the validation and analysis of the results. The period is also too short to implement the IRC calculations and to comprehensively check their base data internally at the bank in advance as well as the subsequent results. The period of time for credit risk monitoring should be the same as that of the other cycles. Therefore the calculation cycle should be one month.

As regards the liquidity horizon, in principle, each bank should have the option of establishing its own liquidity horizons on the basis of its trading book. The definition of lower limits should be avoided. Such an approach would have the advantage of being more adjustable to changing market situations and to consider sufficiently the characteristics of the bank. The appropriateness of the model parameter could be established by the national regulatory authorities within the scope of model tests.

The suggested lower limits for liquidity horizons have been derived on the basis of the current situation of liquidity markets under stress. It is questionable whether these represent an appropriate time horizon in the long run. In this respect we believe there may be a danger of this type of regulatory requirement significantly limiting the usefulness and acceptance of the IRC as an instrument for internal risk management. In the case of liquidity horizons defined by the regulatory authorities, these would need to be regularly and promptly adjusted according to market developments. On that account no lower limits for liquidity horizons should be set.

The required classification of trade products places great demands on the internal implementation, in particular with regard to the technical and processing solution and functional differentiation between individual asset classes. For this reason, the banks should at least be permitted to implement a unified liquidity horizon for all trading products. However, the shortest time horizon for all trading products should be the chosen one, rather than, as has been suggested, the longest. If a trading product requires a longer duration period then this could be increased in correspondence with the IRC determined on the basis of the short period of time.

c) EBIC Members believe that firms should be allowed, in principle, to use shorter liquidity horizons and lower confidence intervals in combination with a scaling factor. There is however the concern that the practical organisation will be defined in such a way by the regulatory authorities that the scaling factors will be implemented across the board and excessively conservatively. This would in turn significantly limit the practical usability and attractiveness of this alternative.

viii) Validation

Commission services enquiry: *Given the suggested approach to capture the incremental risks soundness standard over a one year time horizon and 99.9th percentile loss, the Commission services are interested in learning how the resulting risk measure could be validated from a quantitative perspective.*

The Commission services are interested in stakeholders' views whether it would be for instance reasonable to validate the underlying model at shorter horizons and/or at lower percentiles? If so, how to ensure that the validation exercise is relevant for the one year 99.9th percentile standard? Also, would different aspects of a model require different validation approaches?

The flexibility built into the suggested approach to capture the incremental risks could potentially reduce the comparability of capital requirements for trading positions across institutions and across jurisdictions.

The Commission services welcome stakeholders' views about how the Directive or supervisory guidance could enhance comparability without unduly limiting firms modelling choices? In particular, would it be productive to require institutions to calculate risk measures for standardised 'test-decks' of trading portfolios, to be used to compare model results across institutions?

Validation and back-testing of a model with a 99.9% confidence level and a 1-year horizon would be very difficult. A possible instrument for validation could be the requirement of a shorter time

horizon or a lower level of confidence. However, banks should be permitted to decide how to internally implement the validation. Only after corresponding market standards for modelling have been developed can concrete validation requirements be established. Also, comparability and international level-playing field are very important.

The regulatory provision of a sample portfolio is not supported, as this in no way reflects the individual characteristics of each bank. The convenience of a validation using a sample portfolio would not justify the individual cost and effort of implementation (market data, evaluation models etc.).

ix) Disclosures

Commission services enquiry: The disclosure of relevant information is important for institutions, markets and supervisory authorities alike.

The Commission services would like to invite stakeholders' comments about whether any additional disclosures under Annex XII of Directive 2006/48/EC which would cover incremental risks, or the trading book more broadly, would be helpful and would further market discipline and level playing fields?

EBIC Members support adequate disclosure and transparency in relation to the regulatory capital for the trading book. A suggestion would be to subject the IRC to the same disclosure requirements as the other Pillar I risks.

Re-securitisation:

With regard to the interim treatment proposed by the Basel Committee for re-securitisations, we welcome the decision that the European Commission has not taken over the requirements concerning the interim charge (para. 50 der Guidelines for Computing Capital for Incremental Risk in the Trading Book). The significant effort to implement an interim solution cannot be justified in our view. Rather than implementing such a short-term solution, banks should focus on enhancing IR modelling for these positions. We do not believe that there will be enough time for firms to adapt the securitisation banking book approach to specific securitisation trading book positions. There are different processes and risk management principles for trading book and banking book positions that need to be considered, making any short-term adjustment particularly challenging. With many of the details yet to be decided, we suggest that the switch of the respective regulations at the beginning of 2009 be re-considered. Much of the work involved will depend on the scope and the extent of positions to be included under the interim solution and the final definition of “re-securitisation”.

We assume that European banks will not have to calculate an interim charge from 2009 onwards and would appreciate clarification to this effect.