German Banking Industry Committee

Die Deutsche Kreditwirtschaft

Comments

on the European Commission's
Consultation Document
Proportionality in the future market risk capital requirements and the review of the original exposure method

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The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

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Comments on the EU Commission’s consultation document on proportionality

Dear Sir,
Dear Madam,

On 26 May 2106, the European Commission published a consultation document on *Proportionality in the future market risk capital requirements and the review of the original exposure method*. We are grateful for the opportunity to comment as follows:

1. General remarks

We welcome the Commission’s initiative to also consider simpler approaches for application of the future Pillar I market risk and counterparty credit risk rules for smaller institutions (see also the “Basic CVA framework” in BCBS 325. The risk categories considered in this context usually have a low share of risk weighted assets (RWAs) in proportion to the entire RWAs and are thus less significant. If, on top of this, the risks considered are low for a certain institution, we believe that simplified rules are called for and make sense.

The end product of its deliberations should be a pragmatic solution that significantly eases the processual burden on smaller institutions compared with application of the Basel Committee on Banking Supervision’s proposed new rules on the standardised approach for measuring market risk and counterparty credit risk.

For this purpose, it is, however, vital that the **following guiding principle** is borne in mind:

Any kind of simplification of the rules inevitably leads to risk being measured more inaccurately, more coarsely, and in most cases also less risk-sensitively, for supervisory purposes. At the same time, the danger of over-statement or – which is more serious from a supervisory perspective – understatement of risk increases in step with the level of simplification. The increased supervisory uncertainty created by coarsening the rules is in any case only acceptable for institutions with a low inherent risk in the positions considered (e.g. in the trading book in the case of simplified market risk rules). “Institutions with a low inherent risk in the positions considered” is also a sensible definition of “smaller institutions” in the context examined here. This definition is based firmly on the respective risk and precisely not on the usual measures of size such as, for example, total assets or number of staff.

But also where low inherent risks are involved, it must be ensured for the above reasons that a simpler basic approach duly leads to higher capital requirements compared with a more complex standardised approach. This is also essential for incentive reasons.

Smaller institutions should at any rate continue to be allowed to choose from among all the supervisory standardised approaches available. They should always be able to use the most complex standardised approach available.

What is more, the discussion on easing the rules for smaller institutions raises the question of which institutions should have access to simplified standardised approaches. For the reasons outlined above, not all standardised approach banks should be allowed to use a simplified standardised approach (basic approach), but only institutions with a low inherent risk in the positions considered. We thus believe that a further threshold needs to be introduced for smaller institutions which, in the case of the market risk rules, should stand alongside the threshold set in Article 94 of the CRR. For market risk, it should be based on net positions and not, like in Article 94 of the CRR, on aggregated gross values irrespective of their sign.

As regards the counterparty risk also considered in addition to market risk in this context, we do not believe that it is necessary to introduce thresholds. Non-trading book institutions should, in particular, continue to be allowed to use the Original Exposure Method (OEM).

2. Specific remarks

2.1 Proportionality in the market risk framework

2.1.1 Question 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.

- Categorisation of financial instruments: Instruments with equity, bond and commodity risk must be assigned to the stipulated FRTB categories. These categories are not available for every financial instrument in every case.

- Availability of sensitivities (delta/vega): While it can be generally assumed that sensitivities should be available for the SBA, the possibility of some banks using other approaches for internal risk measurement cannot be ruled out, so that data will not be available in every case.
  It is, for example, likely that institutions which conclude futures contracts with their customers in commodities business will not calculate any sensitivities for these contracts but apply the respective market value of the contracts.
  Sensitivities in the FX segment are, as a rule, easy to determine. It is, however, important in this respect that the FX position can continue to be calculated on the basis of cash values (FX bonds) and nominal values (customer business). This would make implementation easier and is also in line with the accounting approach. Generally speaking, the availability of sensitivities for determining delta for funds, indices (e.g. iTraxx) or index-linked options may be tricky, as a look-through approach is required in every case. This may require considerable effort in the case of index-linked positions. Deriving sensitivities for illiquid products or risk factors could also be difficult, since under the standardised approach sensitivities are required for each instrument (in internal models, there is the 'non-modellable risk factors' category).

- Maturity bands: Banks' own maturity bands do not have to correspond to the regulatory maturity bands (delta risk for interest rate, credit spread and commodity risk, plus all vega risk). Mapping is required for this. This may involve inaccuracies.

- Exemption from calculation of sensitivities: Where an institution offers customers derivative financial instruments (e.g. in the interest rate or FX segments) and these positions are hedged by identical offsetting transactions, proof of a fully hedged position should result in the institution being exempted in this case from calculation of sensitivities. This ensures that there is no capital requirement.

- General interest rate risk: The FRTB provides for an approach whereby correlations are stressed symmetrically (by 1.25 and 0.75, respectively). This works quite well with unidirectional portfolios (the portfolio only shows profits that would accumulate in the event of additive aggregation in the risk class). In the case of hedged portfolios, correlation stressing leads to unduly high capital requirements and thus sets wrong incentives because risk hedging is not attractive.

- Intra- and inter-category correlations: With intra- and inter-category aggregation, negative square root terms cannot be ruled out (applies particularly to low correlations). As a result, there may be sharp fluctuations in capital requirements that need explaining.

- Stressed option prices: To determine the non-linear price components, an option must be stressed by a factor (depending on how each category is classified). Pricing takes place in the Front Office system. This does not know the instrument's regulatory classification, however. The result is thus a processual divergence in this case.

- Equity: The differentiation according to market capitalisation (large/small) is not necessary for the purpose of simplification in our view if the differentiation in the large cap segment according to emerging market (yes/no) and sectors for all financial instruments is applied.

2.1.2 Question 2 and Question 3

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).

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.

Due to the complexity of the new BCBS standardised approach for measuring market risk, banks with smaller and simpler trading books should have the right to keep using the current framework. This would remove the burden of calculating sensitivities for market risk positions as they are included in the Basel Committee's approach. In addition, a more simplified version of the BCBS standardised approach could be included in the CRR for banks that prefer a more risk-sensitive approach but for which implementation of the extensive granularity of the BCBS standard is too costly. We therefore believe that there should be two simplified approaches for smaller institutions (definition of 'smaller institution' as per section 1: *General Remarks*)

In this context, the current CRR approaches should be examined to see whether they can continue to be used, subject to slight modifications. For example, the present standardised approach may be simplified further: the scenario approach for options and warrants (Article 329 of the CRR) could, namely, be dropped, as it is probably not used by most institutions. What matters is the simplified approach or the delta-plus method.

Interest rate risk and FX risk are particularly important, as these have to be addressed by all institutions even if they have no trading book and such risk lies in their banking book.

In addition, we believe that the calibration of the current CRR standardised approach should be reviewed.

The level of the thresholds:
If implementation of the Basel Committee's fundamental review of the trading book in the CRR leads to rules on assignment to the trading book that force institutions to include additional positions in the trading book, we believe that the thresholds need to be raised accordingly.

Additional comments on application of the thresholds:
In order to achieve a more proportionate application of the trading book rules, the derogation under Article 94 (1) of the CRR should not only refer to Article 92 (3) (b) of the CRR but also cover the entire trading book rules under Articles 102–106 of the CRR. These rules impose an excessive administrative burden on 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 standard (BCBS 352) 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.

2.1.3 Question 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.

It may be assumed that the threshold of 5% of total assets and less than EUR 15 million is more of a constraint.

2.1.4 Question 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.

We favour a), i.e. modification of the thresholds. As we merely propose a moderate adjustment of the thresholds (see Question 2/3), we believe it would be acceptable for institutions below the thresholds to use – like in the past – the credit risk framework to cover this very low market risk.

2.2 Review of the original exposure method

2.2.1 Question 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?

We believe it would make sense to keep the OEM for non-trading-book institutions under certain conditions instead of replacing it with the SA-CCR. The conditions under which the OEM is used should be defined precisely. Its use has been confined to date mainly to non-trading-book institutions, a category that does not appear in the CRR. The scope of application of the OEM could be defined more precisely when reviewing the thresholds set in Article 94 of the CRR.

2.2.2 Question 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 are in favour of leaving the OEM largely unchanged. This method can then also be used for calculating the CVA charge and the leverage ratio.

2.3 Replacement of CEM and SM with the SA-CCR

2.3.1 Question 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?

We prefer proposal (ii) in the consultation document, i.e. introducing the SA-CCR, while keeping the "old" Mark-to-Market Method (CEM) and Standardised Method (SM). The CEM could be useful particularly for smaller institutions with a small derivatives portfolio, whereas large institutions should be given an incentive to use the SA-CCR.

The incentives to introduce the SA-CCR can be explained particularly by the following points: netting of offsetting risk positions; appropriate risk-mitigating recognition of secured transactions; and the clear-cut rules for recognition of securities eligible for netting in general. According to its definition in the Basel Committee's consultative document BCBS 279, the SA-CCR has the following key weaknesses, however:

- On its own, the SA-CRR is, overall, too complicated (examples: hedging set creation, PFE multiplier, supervisory delta for options).
- The recognition of derivatives business, whose replacement risk is reflected by the credit risk, is already significantly increased by additional model factors (PFE, collateral haircuts). In addition, a CVA charge for OTC derivatives under solvency rules has to be taken into account. The alpha factor of 1.4 to be applied under the SA-CCR to both the replacement risk and the PFE appears too high, given the already existing conservative approach.
- SME business is discriminated against, as it does not usually involve an exchange of collateral. It will thus become disproportionately more expensive. Taking the current calibration as a basis, the economic impact on the SME sector in the EU should be taken into account.

Particularly where implementation of the SA-CCR is too complicated and inconsistent (e.g. for derivatives with option components in the PFE), a simpler, more conservative approach could be found. In return, the alpha factor could be dropped from the approach. Sample calculations have shown that the incentive to switch from the CEM to the SA-CCR is evened out by the alpha factor also where the collateral coverage ratio is relatively high. These issues could be discussed in more depth in the course of the future consultation on the SA-CCR.

Yours sincerely,

on behalf of the German Banking Industry Committee,
Association of German Banks

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