

# Comments

on the Consultative Document

“Simplified alternative to the standardised approach to market risk capital requirements” (BCBS d408)

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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-sector 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 more than 1,700 banks.

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Comments on the Consultative Document "Simplified alternative to the standardised approach to market risk capital requirements" (BCBS d408), dated 26/09/2017

The Basel Committee for Banking Supervision (BCBS) published a consultative document on the "Simplified alternative to the standardised approach to market risk capital requirements" (BCBS d408). The German Banking Industry Committee (GBIC) welcomes the opportunity for a consultation. Specifically, we would like to share the following comments:

## **1 Overarching comments**

We share the view that a simple alternative must be provided because of the complexity of the sensitivities-based method (SbM) under BCBS 352 for a large number of institutions, and therefore welcome the opportunity to comment on the proposed alternative "reduced sensitivities-based method" (R-SbM).

However, we are unable to identify any decisive simplifications in the R-SbM, which is supposed to be a simplified alternative to the standardised approach for market risk under BCBS 352. This applies in particular with regard to the necessary technical implementation measures and the required data input. For example, the proposed simplified alternatives to the standardised approach would also require the establishment of a separate data repository containing all the information necessary for calculating own funds requirements. Establishing such a data repository and the still complex methodological approach that would sit on top of it would cause high fixed costs for technical implementation. The foreseeable implementation effort and expense are very difficult to assess, especially for small institutions.

In this respect, retaining the existing Basel II standardised approach as a simplified alternative approach, possibly after risk-sensitive calibration, appears to be a more appropriate solution for achieving the stated goal of less complex calculation. The advantage of such an approach is that the institutions in question would not have to make any far-reaching adjustments to procedures and processes. A simple risk-sensitive recalibration could be based on different weightings of risk factors or groups of risk factors, as also contained in the proposed sensitivities-based methods.

As a result, we strongly urge retaining the "Basel II approach".

We also take the view that the criteria for application in the section "Governance" are not practicable, since business activities that already feature in simple business models could prevent the use of the simplified alternative approach. For this reason, the proposed requirements implicitly constitute an intrusion into existing business models, because banks – if they are to continue certain business activities – could be forced to apply the complex new standardised approach, even though its introduction would be accompanied by undue effort and expense.

Although the R-SbM does appear to be less complex overall than the standardised approach under BCBS 352 (sensitivities-based-method, SbM), the approach does differ considerably from the existing Basel II standardised approach at a conceptual level, which is likely to entail considerable additional challenges, effort and expense for its functional and technical implementation.

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The R-SbM only considers delta risk, and thus no vega and curvature risk compared with the normal standardised approach for market risk under BCBS 352. Because the application criteria stipulate that it may only be applied (see "Governance" section) if the bank has very limited market risk exposures from writing options, dispensing with vega and curvature risk does not constitute any significant simplification or relief.

The methodology for computing the default risk charge (DRC) and the residual risk add-on (RAAO) continues to apply in full in the new R-SbM, i.e. no simplified alternatives apply to these calculation requirements.

In general, the new R-SbM features a more conservative parameterisation than the new standardised approach for market risk under BCBS 352, as the risk weights are mostly higher. The derivation or substantiation of the parameterisation is not discussed. In light of the conservative parameterisation compared with the normal SbM, it is additionally not evident why restrictive application criteria should be defined.

The EU-Commission draft of the amended European Capital Requirements Regulation (CRR2) proposes that banks with a low level of exposure to market risk would continue to use the existing Basel II standardised approach as a simplified standardised approach for market risk. We support this proposal and are therefore asking you to harmonise and coordinate your own approach with it.

## **2 Specific comments**

Our detailed comments are presented in the following. In particular, they describe the reasons why we do not believe that the proposed R-SbM is suitable as a simplified standardised approach.

### **2.1 Section 1 Governance (paragraphs 204 – 208)**

With the exception of the quantitative threshold based on the total of the absolute fair values of the trading positions, the criteria for applying the R-SbM in paragraph 204 of the Consultative Paper differ in substance from the criteria for applying the simplified standardised approach in the European proposal in CRR2 discussed above (Article 325a(1)). We are therefore asking you to harmonise and closely coordinate your own approach in this respect. At the same time, the criteria must be reassessed on a quarterly basis and their applicability is subject to supervisory approval. Monitoring these criteria is thus associated with additional process-related complexity. From the perspective of the German Banking Industry Committee, reviewing compliance with the criteria for using the R-SbM once a year is sufficient, especially in light of the fact that only smaller institutions or institutions with no significant exposures and less complex positions with considerably lower trading book turnover would be affected by the simplified approach.

In addition, in particular for smaller institutions relative thresholds enable no sharp distinction for justifying the need for more complex approaches. In this relative consideration, however,

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especially the proposed 5% appears far too low. This level could already be reached due to long-term, non-trading-driven market risks from foreign exchange and commodity spot positions that do per se not justify any exclusion of the simplified standardised approach. We therefore propose to include - in line with the calculation of the absolute threshold - only trading book positions in the calculation of the relative threshold and to increase the relative threshold at least up to 20%.

We do not understand the strict "ban" on writing options. It runs counter to the fundamental approach of simplification in the form of dispensing with vega and curvature risks, as these are only ever relevant in the case of options. The supposed relief would thus simply not happen in practice. Moreover, this hard criterion would mean a concrete intrusion into the standard business activities of smaller banks in particular. The reason is that such banks often are not able to use more advanced methods. At the same time, however, they use recognised option strategies to enable more efficient market risk management and cannot therefore forgo writing options.

A complicating factor is that, as it stands, the wording is not clear as to whether written options in the banking book are to be included in the application criteria. The strict ban on writing options should therefore be deleted in its entirety or at least be extended to include additional exceptions and a materiality threshold. In this context, we suggest revising the second bullet in paragraph 204 as follows:

*"The sum of all delta equivalents of the options written by the bank must not exceed €10 million (with the exception of back-to-back options, covered options whereby the bank owns the securities it may need to deliver or no additional payment obligation results under the terms of the option, and options held as strategic "macro hedge" positions for the banking book)."*

The proposed quantitative application condition based on an aggregate notional amount of all (i.e. in both the trading book and the banking book) non-centrally cleared derivatives is not coherent. We cannot identify any connection with authorisation of a simplified approach for market risk. Please delete this criterion.

Additionally, the BCBS document does not specify any applicable transitional periods for institutions that exceed or fall below the thresholds.

Finally, we would like to voice our rejection of the general exemption of larger institutions from the scope, in particular of D-SIBs and O-SIBs. On the contrary, the rest of the list of criteria is designed to ensure that only institutions with low market risk exposures can use the R-SbM, which could also include significant institutions depending on their business model. Examples of significant institutions with low market risk exposures in Germany are certain development banks and Pfandbrief banks. These institutions should also be able to benefit from a simplified standardised approach for reasons of proportionality. An indication of a corresponding risk-sensitive approach is provided by the BCBS itself in the background to the Consultative Document, where it writes:

"As a standardised approach, however, the complexity of the SbM may pose implementation challenges for some banks (eg banks with a low concentration of trading book activity and smaller banks that typically do not have sufficient infrastructure for computing the SbM).

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Moreover, in some jurisdictions, large banks face less complex risks. Broadly speaking, the current requirements of the SbM make the revised market risk framework's standardised approach difficult or not necessarily appropriate to implement and adopt across all Basel Committee on Banking Supervision member jurisdictions and non-member jurisdictions."

## **2.2 Section 2 R-SbM: structure (paragraphs 209 – 210)**

The aggregation rule for calculating the capital requirement for delta risk only differs from the corresponding aggregation rule in the new BCBS 352 standardised approach for market risk in terms of one calculation step (delta charge is determined by the amount of the summands in the square root formula). There is hence no significant simplification compared with the complex SbM.

## **2.3 Section 3 R-SbM: definitions of the risk factors (paragraphs 211 – 218)**

Two delta sensitivities – for the five-year or shorter-than-five-year tenor and for the longer-than-five-year tenor for each yield curve – are needed for general interest rate risk (GIRR). This rough approach is insufficient to do justice to the goal of greater risk-sensitivity, and this will ultimately entail incentives for mismanagement in the form of "cliff effects". The definition of risk factors that are remote from economically appropriate management also leads to the establishment of parallel data repositories and hence to implementation effort and expense when additionally calculating "Pillar 1-compliant" risk sensitivities.

For inflation risk and cross-currency basis risk, the methodology for calculating the delta risk factors corresponds to the one used in the new BCBS 352 standardised approach for market risk. The same applies to delta risk from equity prices, commodity exposures and foreign exchange risk, so there is also no relief here compared with the new BCBS 352 standardised approach for market risk.

The R-SbM does not explicitly address the delta risk from equity repo rates, which represents a simplification compared with the new BCBS 352 standardised approach for market risk. However, the question of the extent to which these risk factors are not to be capitalised or e.g. used in the RRAO is left open.

## **2.4 Section 4 R-SbM: Prescribed buckets, risk weights and correlations (paragraphs 219 – 252)**

Compared with the SbM, the Consultative Paper on the R-SbM contains the following burdensome parameterisations on general interest rate risk that do not appear to be justified:

- At 5%, risk weights for delta GIRR from yield curves are more than double what they are in the BCBS 352 SbM (between 1.5% and 2.4%, depending on the maturity). In addition to the far too high risk weights, we believe that using only two maturity buckets is too few – even in a simplified approach – to allow an at least approximately adequate assessment of

risk-reduced portfolio effects. The plausibility and risk sensitivity of the calculated risk positions cannot therefore be determined – or only to a limited extent – and thus do not represent any significant advance over the existing standardised method.

- At 3%, risk weights for delta GIRR from inflation and cross-currency basis risks are higher than in the new BCBS 352 standardised approach for market risk (2.25%).
- At 20%, we cannot understand why correlation parameters for buckets within delta GIRR risk factors from yield factors are considerably lower than in the new BCBS 352 standardised approach for market risk or the draft CRR2. In the case of any opposing alignment of the buckets, this can lead to significant, inappropriate risk overestimation, thereby preventing economically sensible management activities or encouraging misdirected incentives and potential management errors.

The segmentation for delta CSR risk factors from non-securitisations is considerably less granular than in the BCBS 352 SbM. However, the risk weights are in part many times higher. For certain instruments (e.g. covered bonds, financials) this means that the own funds requirements would be so high – and not only in the longer maturities – that the credit spread risk inherent in these instruments would be exaggerated to a point where it can no longer be termed realistic. Consequently, these instruments are no longer likely to be considered as trading book positions because of the excessive own funds requirements. This is implicitly the equivalent of an intrusion into existing business models and should be avoided. In addition, the proposed sector classification is too undifferentiated, even for a simplified approach. Because of their double collateralisation (a feature that needs to be emphasised), covered bonds would have to be allocated to a separate bucket, as in the BCBS 352 standardised approach. In line with the less granular segmentation, the correlation parameters are also less granular and not directly comparable.

A risk weight of 32% for specific currency pairs defined by the BCBS and of 45% for all other currency pairs applies to delta risk from exchange rates. This represents a considerable increase in the risk weights, as they are approximately 21% and 30% respectively in the new BCBS 352 standardised approach for market risk. The correlation between foreign exchange risks of different currency pairs remains unchanged at 60%. Because of the increase in the risk weights, a higher capital requirement compared with the new BCBS 352 standardised approach for market risk can be expected especially for foreign exchange risk. There is no difference between the calculation rules in the R-SbM and the BCBS 352 SbM for own funds requirements for foreign exchange risk sensitivities. Because there is thus no simplification for the "foreign exchange" risk factor in the simplified alternative, we believe that the risk weight of 45.0% specified in paragraph 251 is inappropriate.