EAPB's position on the BCBS consultation on the simplified alternative to standardised approach to market risk capital requirements

The EAPB would like to provide the Basel Committee on Banking Supervision with the following specific comments:

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 for CRR2 (Article 325a(1)). We are therefore asking you to harmonise and closely coordinate your own approach in this respect. Moreover, the criteria in paragraph 204 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 EAPB's perspective, 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.

Looking at the different criteria in the governance section, the eligibility criteria should be limited to the relevant area, i.e. the trading book. It should not be based on other metrics, such as a bank being a G-SIB or D-SIB or not.

More in detail, for the first point of Art. 204., 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.

Considering the second point 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 and 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.
Should the Committee feel that his condition would be of absolute necessity, it should 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).*"

Regarding the 5th point of Art. 205, the EAPB believes that relative thresholds are not a suitable definition criterion for justifying the need for more complex approaches, particularly so for smaller institutions. In this relative consideration, however, 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 risk spot positions that do per se not justify any exclusion of the simplified standardised approach. We therefore propose include- in line iwth the calculation of the absolute treshold- only trading book positions in the calculation of the relative threshold and to increase the relative treshold up to at least 20%.

As for point 6, 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. We would there also ask to please delete this criterion.

About Art. 205, In order to ensure a level playing field, the EAPB believes that the supervisor should not have the discretionary power to exclude a bank from using R-SbM when it meets all the criteria specified in art.204. We then propose to amend Art.205 accordingly.

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

The EAPB notes that he 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.Possible amendments to achieve this simplification would be welcome.

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 the EAPB does not see any relief here either 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. This should be further clarified.

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

Furthermore, 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 weightings are in part many times higher. For certain instruments (e.g. covered bonds, financials) this means that the own funds requirements would 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.