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Comments on the Basel Committee on Banking Supervision's Consultative Document: Fundamental review of trading book capital requirements

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the consultative document: Fundamental review of the trading book, released on May 3, 2012 by the Basel Committee on Banking Supervision (the "Committee").

We hope that our comments below will be of assistance and perhaps offer an additional point of reference as you work towards finalizing the rules proposed by the Committee.

"3.1 Reassessment of the boundary"

Q1 Which boundary option do you believe would best address the weakness identified with the current boundary, whilst meeting the Committee's objectives?

We support the "trading evidence-based boundary".

From an Asset Liability Management (ALM) perspective, assets held in the banking book are managed integrally with the corresponding liabilities. If the "valuation-based boundary" is adopted and only financial instruments measured at fair value for accounting purposes (i.e., available-for-sale securities under the Japanese GAAP) are classified into the trading book, the asset side will be subject to capital requirements for the trading book while the liability side, which is managed on a cost basis, will not. Such treatment may result in excessive capitalisation compared to the amount of net interest rate risk, which assumes management of the asset side taking into account the liability side managed on a cost basis. Further, if the "valuation-based boundary" approach is adopted, securities (e.g. government bonds) which currently booked in the banking book will be measured at fair value and moved to the trading book. This shift from the banking to the trading book would subject these assets to market risk capital requirements and, thereby result in, significantly higher risk-weighted assets (RWA), considerable impediments to the ability of financial institutions to hold government bonds in the medium- and long-term and amplification of procyclicality against interest rate risk.

In addition, although the "valuation-based boundary" has the merit of having an explicit definition, since the bank's capital under this approach is regulated based on an accounting standard whose conceptual underpinnings are different from that of prudential regulation, considering the fact that the accounting standards currently differ among jurisdictions, it may result in imposing unbalanced capital regulations.

Moreover, future revisions to accounting standards may result in further transfer of assets between the books. Thus, this approach is considered inappropriate.

On the other hand, the "trading evidence-based boundary" is considered to be a more preferable approach as it aligns with banks' business operations and risk management practices. Ensuring alignment with the business operations and risk management framework is a crucial element for assessing the soundness of the banks. Lack of such alignment may contribute to the failure in controlling portfolio risks, ultimately inhibiting sound banking operations.

Under the Japanese laws and regulations, the banking book and trading book are segregated, and the assets which can be booked in the trading book are stipulated in detail. Transfer of an asset between the two books is in principle prohibited. The trading book has been under strict supervisory scrutiny, and hence no particular issue has arisen in connection with boundary arbitrage in Japan. Based on our experience, it would be necessary to develop the clear policy and framework consistent with banks' business model including the type and size of instruments the banks hold in the trading book. The policy and framework would form banks' "trading evidence" and constitute clear and objective boundaries for both books. In addition, rigorous supervision by the regulators on compliance of the banks' policy and framework, would help remove boundary arbitrage by banks and would address many of the shortcomings of the current regime. We believe that these efforts by both banks and regulators would offer a fundamental solution to addressing the issue of regulatory arbitrage recognized under the current boundary.

"3.1.A A trading evidence-based boundary"

We support the "trading evidence-based boundary", but strict "evidence" should not be required. There are instruments for which a bank has a trading intent but lack liquidity (e.g. complex derivatives). These instruments should not be uniformly classified in the banking book. Rather, we believe that such instruments should be classified in the trading book in accordance with the bank's trading intent, with consideration of liquidity horizons adjustment based on the instrument's market liquidity as specified in Section 3.3, thus enabling appropriate risk measurement. Classifying these instruments in the banking book for regulatory purposes could magnify inconsistency between the asset classifications based on the accounting standard and could result in considerable confusion.

Moreover, we are of the opinion that the requirements to both specify an expected maximum holding period for an instrument and to conduct a backtesting between the expected and the actual period are unnecessary. Whether to hold instruments with trading intent or to actually replace all of the instruments within a certain period of time should be treated as different issues. It is a common practice to carry out market risk management of the trading book on a portfolio basis, rather than on an individual instrument basis. For example, especially in cases of bilateral transactions, even an instrument with sufficiently high liquidity such as a plain vanilla interest rate swap is usually held until maturity, while hedging the instrument's risk with similar products or products in the same risk category at the portfolio level. In

addition, depending on market outlook, banks could intentionally hold instruments which are sufficiently liquid, for a longer period of time. The requirement to specify an expected maximum holding period, when considered against the above, is inconsistent with current banking practices for managing the trading book.

"3.3. Factoring in market liquidity"

Q2 What are commenters' views on the likely operational constraints with the Committee's proposed approach to capturing market liquidity risk including the endogenous component and how might these be best overcome?

"3.3.2 (1) Varying liquidity horizons in the regulatory market risk metric"

Varying liquidity horizons that factor in only exogenous characteristics are determined depending on the characteristics of products and markets, rather than situations unique to each financial institution. In order to estimate and quantify varying liquidity horizons for enormous kinds of products in an appropriate and objective manner, it is necessary to consider multiple factors such as products, positions and market share. In practice, relevant data for quantifying varying liquidity horizons might not be readily available and the calculation logic might become complicated.

For example, only limited objective data that demonstrates market liquidity is available for OTC derivative and other new transactions for customers, and the estimation of market size for these transactions/products is not simple. Additionally, quantifying liquidity horizon will become more difficult when the transactions/products are illiquid due to unique character or structure and the contract maturities of the transactions/products are quite long.

Uniformly requiring the proposed capital charge using long-term horizon for these customer transactions as well as positions associated with these customer transactions may inhibit market development, and lead to weakening in the financial intermediary function.

Further, for analyzing liquidity horizon for the transactions/products, it is doubtful whether "observable market data during a stress period" may be readily available.

Accordingly, for the introduction of the liquidity horizon bucket, it is preferable, from the perspective of ensuring a level playing field and objectivity, for the regulators to establish the liquidity horizon bucket, or to set forth clear, objective and detailed application standards. Also, we would expect the regulators to avoid requiring excessively conservative capital charge for customer transactions. As another effective alternative option, we would propose an approach to limit the scope of application to complicated and illiquid instruments and require capital add-on to such instruments.

Under the definition proposed by the Consultative Document, it is unlikely that a position could not be

closed out at all during the liquidity horizon. The required capital amount of the position therefore should be calculated under the assumption that the position can be closed out to the extent that such closing transactions do not affect market prices via market liquidity.

"3.3.2 (2) Capital add-ons for the potential for jumps in liquidity premia"

We do not support the proposed approach to require banks to hold add-on for the potential for jumps in liquidity premia. This is on the basis that there is a practical limitation on obtaining actual volatility data for related risk factors in calculating add-on for the potential for jumps in liquidity premia.

"3.3.2 (3) Accounting for endogenous liquidity risk"

We would like to express our dissenting opinion on the proposed additional capital charge to endogenous market liquidity risk, because the proposed regulatory regime to require each financial institution to assess whether an additional capital charge needs to be applied to endogenous market liquidity risk by factoring in characteristics unique to a portfolio of each financial institution would not be appropriate in the light of ensuring objectivity and a level playing field.

Valuation and risk calculation incorporating endogenous market liquidity risk (such as concentration risk) have a wide and significant impact to financial institutions' system developments, and therefore such proposed requirement is considered to be impracticable to implement only for regulatory purposes.

If the capital requirement on endogenous market liquidity risk were to be introduced, a potential solution would be to incorporate it into a liquidity horizon, with two sets of horizon floor established; one that considers liquidity of the product and the other that incorporates endogenous liquidity risk factors. In addition to this, the regulators would need to define quantitative criteria in determining whether additional capital charge is required as well as the level of capital charge.

"3.5 Relationship between the standardised and internal models-based approach"

Q3 What are commenters' views on the proposed regime to strengthen the relationship between the standardised and internal models-based approaches?

We would like to voice our objection to the proposed approach to use the standardised approach as a floor or surcharge on the amount of risks generated from the internal models-based approach.

This is because introducing a standardised floor or surcharge into the internal models-based approach lacks rational, and would interfere with a banks' incentive to adopt the internal models-based approach, considering that the Committee has already revised their calculation and validation methodologies of the internal models-based approach by placing various restrictions.

A standardised floor or surcharge, if introduced, should be set in a manner to allow banks to sufficiently benefit from an incentive to shift to the internal models-based approach.

Additionally, we would like to render our opposing view to the proposed approach to require all banks using the internal models-based approach to also calculate the required capital based on the standardised approach, because there would be additional high cost and operational burden to run the standardised calculation in parallel with the internal models-based calculation as to implement the proposed mandatory standardised measurement.

"4.1 The overall approach to internal models-based risk measurement"
"4.2 Defining the scope of instruments eligible for internal models treatment (steps 1 and 2)"
Q4 What are commenters' views on the Committee's proposed desk-level approach to achieve a more granular model approval process, including the implementation of this approach for banking book risk positions? Are there alternative classifications that might deliver the same objective?

There would be concern that achieving more granular classifications into desk-level approach than the current regime may hinder the banks' incentive to improve the sophistication of their internal models.

If the desk-level approach were to be adopted, eligibility for the internal models-based approach would not need to be assessed at the overall trading book level. Conversely, if the eligibility at the overall trading book level is emphasized, the desk-level assessment of eligibility would not be appropriate.

Additionally, it should be fully taken into consideration that it is extremely hard for banks to manage risk at the desk level due to the current operational practice.

In the context of the definition of the desk under the proposed "desk-level approach", the organizational units for eligibility assessment are further disaggregated, increasing possibility of more units or desks failing to pass the criteria. Also the assessment result of eligibility might frequently change because of the changes in desk-level performance due to traders' reassignment or reorganization.

If a bank holds positions which are offset between desks, or if the assessment result on the eligibility for the internal model being divided across these desks, risks may be excessively measured at the overall trading book level.

In addition, it would be a high burden for a bank to develop a framework based on an internal-model based approach for all desks, risk categories and instruments, considering desks with a limited benefit and risk categories with a significant burden for measuring risks using the internal models-based approach.

We therefore propose that banks, at their discretion, should be allowed to set a trading-desk level which is not necessarily consistent with their organizational structure by considering positions the banks hold; and also be granted an option to select the standardised approach for certain desks, risk categories and instruments. At least, rules should exclude the possibility that the regulatory definition of the desks may restrict a timely and appropriate organizational change by a bank.

"4.3 Identification of modellable and non-modellable risk factors (step 3)"

Q5 What are commenters' views on the merits of the "direct" and "indirect" approaches to deliver the Committee's objectives of calibrating the framework to a period of significant financial stress?

The "direct" approach has merit in that it provides more granular risk measurement for instruments with complicated risk sensitivity such as non-linear risk. However, it would be difficult to obtain a sufficient sample size (i.e., market data) to estimate expected shortfall ("ES") during stress periods.

On the other hand, the "indirect" approach would be of use when historical data is not available or from a perspective of reducing the calculation burden. By this approach, a bank is able to achieve sufficient granularity and accuracy in cases where the bank holds no instruments with complicated risk sensitivity.

In identifying a stress period, it is desirable to allow banks to adopt the indirect approach or an alternative approach which imposes a lower calculation burden, depending on the risk profile a financial institution holds and other factors.

Q6 What are commenters' views on the merits of the desk-based and risk-factor based aggregation mechanisms to deliver the Committee's objectives of constraining diversification benefits?

Under the desk-based aggregation, if a single desk holds risks with risk factors which belong to multiple broad risk classes, risks are allocated to a single broad risk class, considering the risk characteristics of such a desk. However, such an approach is considered to be inappropriate as it would significantly decrease the diversification effect and accuracy of risk horizon.

On the other hand, the risk-factor based aggregation mechanism has the flexibility to an organizational change without arbitrariness arising from drawing a line between desks and enables appropriate assessment for instruments with sensitivities to various risk factors.

Q7 How can regulators ensure robust supervision of integrated market and credit risk modelling? In particular, how would an integrated modelling approach affect other elements of the proposed framework (eg the choice of the quantile parameter for ES, the P&L attribution and backtesting processes, etc)?

We hold the view that the integration of market and credit risk modelling is difficult.

Under the integrated market and credit risk modelling, as a credit event rarely happens and the period of risk extends to the long-term, a sufficient sample size would not be available for backtesting and P&L attribution purposes, leading to a concern that the adequacy of risk factors associated with credit risk may not be proven.

Moreover, because default and credit rating transition will cause a discrete price changes and these credit-related risks highly depend on individual characteristics, it is difficult to measure default and migration risk considering the effect of offsetting with market risk factors. This would even give rise to a concern that the market risk management would fail to function.

"4.6 Ongoing monitoring of approved models"

Q8 What are the likely operational constraints with moving from VaR to ES, including any challenges in delivering robust backtesting, and how might these be best overcome?

Moving to expected shortfall

It is widely recognized that the expected shortfall (ES) has several advantages over VaR; for example, ES can capture tail risk; has characteristics that are preferable from a conceptual perspective as a risk measure; and has received a certain degree of appreciation from an academic aspect. The necessity of capturing tail risk for regulatory purposes is also understandable.

However, a sufficient cost and benefit analysis needs to be carried out considering both advantages and disadvantages in terms of the significance and impact of introducing ES. Compared with VaR, ES imposes a high operational burden in ensuring ongoing measurement and validation in a precise manner, and therefore moving from VaR to ES places a tremendous additional burden on financial institutions. In addition, if ES is introduced only for market risk, what total risks aggregated with risks in the other categories (VaR) implies would become unclear.

Whilst, VaR is a well established approach within the basic framework of capital allocation and risk management for internal management purposes at financial institutions. Financial institutions also continue to use VaR as a risk measure for credit and operational risks for regulatory capital adequacy and internal risk management purposes.

For meeting the objectives of ensuring alignment of regulatory capital requirements with risk management for the bank's internal management, and at the same time capturing tail risk, we believe that a solution to maintain the current VaR-based framework with a liquidity horizon for illiquid instruments and increase the

confidence level of VaR would be sufficient to address such objectives.

Meanwhile, we understand the Committee's intention to clarify theoretical backgrounds of existing capital requirements related to market risk and to introduce ES in order to overcome limitations inherent to VaR. However, it is considered necessary to sufficiently contemplate the possibility that ES, if embedded into the capital requirements, may impose excessive capitalisation on financial institutions, when combined with other requirements such as the introduction of market liquidity horizon, calibration to stressed conditions and a regulator-defined correlation parameter.

As mentioned above, since ES is not suited for use as a risk measure within the day-to-day risk management framework of financial institutions, we respectfully propose that the requirement on the use test for ES under the internal models-based approach should be relaxed to a considerable extent, or ES be exempted from such use test, allowing, for example, the cases where VaR calculated based on the same assumption is used for internal management purposes. Furthermore, a sufficient transition period should be set for introducing ES because the development of the ES model and its validation methodology and system development entail considerable costs and time.

ES measurement approach

Full repricing is assumed as an ES measurement approach. However, approaches which do not rely on full repricing should be allowed in cases where the effect of using full repricing is limited, such as for instruments with simple risk characteristics whose profits and losses can be sufficiently approximated by using a simplified method based on the first- and second-order sensitivity or other factors.

The multiplication factor (internal 99% VaR measure multiplied by three) used under the current regime should be removed because there is no clear basis for using such a factor and its continuous use lacks significance and reasonable justification, given that the purpose of the proposed amendments to the current regulation is to enhance capturing of tail risk, market liquidity risk and other risks by using the internal models-based approach.

Treatment of hedging and diversification benefits

With regard to the calculation of capital charges for each broad risk class, it is not considered necessary to introduce a floor based on the amount aggregated by use of supervisory determined/restricted correlations.

Ineffectiveness of hedges during the stress period arises not across risk classes including interest rate and foreign exchange but within the same risk class such as an expansion in the basis risk.

Strictly constraining the benefits of hedging and diversification effect between risk classes, in spite of allowing certain latitude in considering diversification benefits within risk categories, might interfere with

the banks' incentive to adopt and enhance the internal models-based approach.

P&L attribution

The sample period "the standard deviation of the actual P&L," which is used as a denominator to compute the metrics under the P&L attribution assessment, should be set sufficiently long so as not to lack effectiveness as metrics in cases where the sample period is short, the market volatility is low and actual P&L continues to remain at a low level.

With respect to the frequency of reporting metrics, considering the sample period and other factors, it does not seem always necessary to report the metrics on a monthly basis. We therefore respectfully request that requirements of the frequency of reporting be relaxed.

Actual P&L includes various factors which should be excluded from the assessment of the degree of precision of the models such as P&L arising upon trade execution/termination of contracts and realized P&L attributable to transactions entered into/closed intraday. However, the exclusion of such factors is practically difficult and therefore, in practice, the hypothetical P&L is used for backtesting. Using such an inaccurate actual P&L as a factor to compute the metrics might lead to a risk of an erroneous judgment.

Backtesting

Under the ES backtesting, the tail of the P&L distribution is included in the measurement result and calibration with data during stressed period is required. Therefore, it is considered difficult to validate the reasonableness of the theoretical P&L distribution and determine a multiplier theoretically by taking account of the number and size of backtesting exceptions. In assessing the difference between losses above the confidence level and ES estimates, it is uncertain whether the backtesting satisfactorily functions without a sufficient sample size. In this regard, we expect that further discussion be made as to backtesting approaches and methodologies to determine tolerable levels.

Treatment in cases of being determined as "not eligible" for the internal models-based approach

With regard to moving to the standardised approach when being determined as not eligible for the internal models-based approach, even if the standardised approach becomes a mandatory requirement, we request that a sufficient transitional period is granted considering time and costs required for system developments/modifications by financial institutions.

"5 Revised standardised approach"

Q9 Which of the two approaches better meets the Committee's objectives for a revised standardised approach?

The fuller risk factor approach has the advantage of high risk sensitivity which properly reflects hedging and diversification benefits. On the other hand, the partial risk factor approach has the merit of being

"simple", but has the disadvantage that it cannot fully reflect the offset of positions and therefore risk amount might be measured at an excessively conservative level and also the risk sensitivity tends to deteriorate. It is concerned that those disadvantages of the latter may be crucial for a regulatory framework.

We are unable to reach a definitive view until more details are proposed and we understand the respective advantages of the simplicity of the partial risk factor approach and the accuracy of the full risk factor approach based on the calculation results. However, it is desirable to allow both approaches as a standardised approach, and to give banks a choice to select from these two approaches.

Q10 Do commenters propose any amendments to these approaches?

Since market risk management based on the grid-point sensitivity is a widely used approach across financial institutions, "duration method" (measurement methodology that uses sensitivity) which is common under the current regime shall also be permitted for general interest rate risk calculation in the partial risk factor approach.

The revised standardised approach proposed in the Consultative Document would contribute to the enhancement of risk management as it refines the current approach. However, the revised standardised approach is significantly complicated as compared to the current approach, resulting in a considerable calculation burden. The benefits of elaborating the approach are considered to be limited and not to outweigh increasing burden of framework development and calculation for small-sized banks and banks which deal relatively simple financial instruments. Given the regulatory purpose of providing a simplified calculation approach, we respectfully request that a simplified approach such as the current standardised approach be also allowed.

Other

Interest rate risk capitalisation on the banking book

We propose that the interest rate risk on the banking book should be continuously covered under the Pillar 2 framework, since, from an ALM perspective, assets held in the banking book are managed integrally along with the liabilities, and since both are indivisible in identifying interest rate risk. Meanwhile, the underlying concept of the nature of deposits and core deposits such as stickiness significantly differ across jurisdictions, and therefore it is difficult to apply uniform criteria for quantifying interest rate risk profile of the banking book within the Pillar 1 framework. Accordingly, in order to properly reflect the differences across jurisdictions, the interest rate risk on the banking book should be monitored with sufficient communication by the regulators within the Pillar 2 framework.