February 20, 2015

Comments on the Basel Committee on Banking Supervision's Consultative Document
"*Fundamental review of the trading book: outstanding issues*"

Japanese Bankers Association

We, the Japanese Bankers Association (JBA), would like to express our gratitude for this opportunity to comment on the *Fundamental review of the trading book: outstanding issue* issued by the Basel Committee on Banking Supervision (the "BCBS).
We have been requesting the BCBS to establish a framework that is consistent with banks' business management and risk management practices. Comments provide below are built on this fundamental view.
We respectfully expect that the following comments will contribute to your further discussion on finalising the rules.

<<1. Our responses to the questions>>

Q1. What are your views on the specific refinements described in the three sections of this consultative document?

Although the review has not yet determined treatments in details for the three areas, every issue has been discussed for review from practicable perspectives, and therefore we support the direction. We however have the following comments:
It is understood that the purpose of the review of the standardised approach in this consultative document is to enhance comparability across banks regarding the risk amount, while ensuring a certain degree of risk sensitivity. Prescribed parameters used in this consultative document however are excessively conservative relative to the historical trend of prices. Risk sensitivity therefore is not considered to be maintained at an appropriate level. Additionally, since the difference in the depth of the markets for the primary currency and other currencies is wide, setting a uniform parameter across currencies may distort the risk sensitivity, and may provide an inadequate incentive to market participants. Specifically, there is an issue on parameter setting for cross currency basis, which is discussed in details in 2.(2) of <<2. Other requests and matters to confirm>>.

Q2. Do these specific proposals strike the right balance between simplicity, comparability and risk sensitivity?

We support the sensitivity-based approach (SBA) which is proposed as an alternative to cash

flow-based calculations for the standardised approach, because this change in the approach would improve the risk sensitivity.
Considering that the standardised approach serves as a fall-back or back-up function for the internal models approach, however, there is a concern that this approach may lack simplicity to some extent. For example, the formula for calculating capital requirements for non-linear risk (curvature risk) is complicated. In particular, for banks with a limited trading volume of products with complicated optionality, there is a concern that the SBA might impose excessive cost and burden relative to risks SBA intends to capture. While it is very meaningful to consider incorporating non-linear risks that could not have been captured into the standardised approach, it is respectfully requested to fully consider striking an appropriate balance between merits and burden.
Additionally, we strongly oppose to the use of the standardised approach for the floor of the internal model approach. Because, if the standardised approach which produces excessively conservative outcome is used as a floor for the internal model approach, this would undermine the banks' purpose to carry out reasonable internal risk management activities that suit to their own risk profile, and may impede appropriate risk management which banks should pursuit.
For internal risk transfer between the banking book and the trading book, since "exact match" which is one of significant considerations to be made is not clearly defined, it is strongly requested to refine the definition.

<<2. Other requests and matters to confirm >>

1. Treatment of internal risk transfer between the banking book and the trading book
(1) Internal risk transfer between the accounts (Section 1.1 and 1.2)
With respect to the "pass-through approach" used for internal risk transfers between the accounts, it is requested that the "exact match" requirement related to internal risk transfers and external cover transactions should be defined in a manner consistent with those set out under accounting principles and standards of respective jurisdictions.
As compared to corporates, financial institutions frequently use internal risk transfers as hedging instruments, which are carried out on a cross-border basis. Under such situation, in some cases, it may be difficult to execute external transactions concurrently, and under the same conditions, with all inter-company transactions and internal risk transfers, taking into account issues associated with time differences and whether transactions can be executed in markets.
Therefore, for the "exact match" requirement, it is requested to permit firms to apply similar treatment to that set forth under accounting standards established at respective jurisdiction that are accepted as enabling firms to operate a strict hedging activities by eliminating arbitrariness. (For example, cover transactions is executed under the same conditions as

internal risk transfers within 3 business days.)
Additionally, since the treatment of transaction which is not deemed as "exact match", including internal risk transfer, is not clear, it is requested to duly consider and clearly specify a reasonable treatment.

(2) Treatment of instruments exposed to both FX and general interest rate risks (Section 1, Section 2.6.2, and Annex 1 Paragraphs 17 and 81)

A method that is consistent with business practice established across financial institutions is that FX risk should be offset regardless of maturities and that risks associated with instruments exposed to FX and general interest rate risks (GIRR), such as forwards and currency swaps, are decomposed into "FX risk (of spot transaction)" and "GIRR", which are managed separately. It is therefore considered that such treatment should be adopted.
If risks arising from such transactions are all treated as "FX risk", the BCBS is requested to clarify the treatment of the "GIRR", for example, specify that GIRR needs not be measured.

(3) Treatment of Option 2 for internal risk transfers of interest rate risk (GIRR Option 2) (Section 1.2)

If internal risk transfers executed by all "desks" are aggregated at a "hypothetical portfolio" level, (i) since the business unit which recognizes revenue (that is, the desk which carried out internal risk transfers) and the business unit for which risks are recognized (that is, the desk to which capital should be allocated) differ, it may become difficult to clearly match risks and revenue, thereby causing difficulty for banks to manage risks and authority related to risks; and (ii) in calculating capital requirements for an entity with a number of subsidiaries, there is an issue that it is technically impracticable to aggregate all internal risk transfers executed by all subsidiaries at a "hypothetical portfolio" level.
From this view, the hypothetical portfolio at which internal risk transfers are aggregated should be permitted to set on a desk-by-desk basis.

2. Revision to the standardised approach for market risk

(1) Treatment of standards approach as a floor (Section 2)

The use of standardised approach as a fallback for the internal models approach (that is as an alternative to the internal models-based approach if the model was not approved) is considered to be reasonable. We however strongly oppose to the use of the standardised approach as a floor of the internal models approach.
Because, if the standardised approach which produce excessively conservative outcome and has inherent limitation as an approach is used as a floor for the internal models approach, this would undermine the banks' purpose to carry out reasonable internal risk management activities that suit to their own risk profile, and may impede appropriate risk management which banks should pursuit.

(2) Setting of various parameters for standardised approach (Section 2)

Various parameters to be used under the standardised approach should be set in a manner to avoid calculating excessively conservative outcomes, taking into account historical price movements, by for example distinguishing between major currency and other currencies.

It is understood that the purpose of the review of the standardised approach in this consultative document is to enhance comparability across banks regarding the risk amount, while ensuring a certain degree of risk sensitivity. Prescribed parameters used in this consultative document however are excessively conservative relative to the historical price movements. Risk sensitivity therefore is not considered to be maintained at an appropriate level.

Additionally, since the difference in the depth of the markets for the major currency and other currencies is wide and hence the level of volatility significantly varies as observed from the time series-data of cross currency basis (see Reference), setting a uniform parameter across currencies may distort the risk sensitivity, and may provide an inadequate incentive to market participants. Similarly to setting liquidity horizons, parameters should be separately set for major currency and other currencies.

From perspectives of individual instruments, for example, cross-currency swaps are often used as a mid-term foreign-currency funding tool for the banking book. If an excessively conservative parameter that does not reflect historical price movements of the currency is set, this would facilitate firms to raise more short-term funds. This would eventually result in an unintended consequence such as an increase in risks at the time of financial crisis.

For example, observing the historical data (remaining maturities of 3yr and 5yr) for USD/JPY and EUR/USD currency basis, the volatility for 60 days is within 50pb at maximum. This means that 1.5% (=50bp x 3 yr) and 2.5% (=50bp x 5yr) of notional amount are considered sufficient for recognising the risk amount (capital charge) for currency swap. While, under the proposed approach, in addition to the change of the sensitivity of FX risk from 8% to 15%, the correlation parameters are set at 0.90 and 0.65, which result in 7% of notional amount (≒ √(15%^2+(-15%)^2+2×0.90×15%×(-15%)) and 13% of the notional amount (≒ √(15%^2+(-15%)^2+2×0.65×15%×(-15%)) for the risk amount (capital charge) for currency swap, respectively. These capital outcomes are apparently overestimated.

If the methodology provide in the Consultative Document would be applied, to calculate an appropriate level of capital outcomes, the reasonable level of correlation parameters between the buckets are considered to be at 0.995 or more for 3yr and 0.986 or more for 5yr, respectively, at least for major currency pairs (USD, EUR, JPY, GBP, CHF, AUD, CAD)[Note].

Note: Calculating the risk amount using the 0.995 correlation parameter between the buckets, the risk amount will be √(15%^2+(-15%)^2+2×0.995×15%×(-15%)) = 1.5%, while if the correlation parameter is set at 0.986, the risk amount will be √(15%^2+(-15%)^2+2×0.986×15%×(-15％)) ≒ 2.5%. These outcomes are considered to be an appropriate level discussed above.

(3) Definition of "sensitivities" under a sensitivity-based approach (SBA) (Section 2, Annex 1 Paragraph 20)

Paragraph 20 of Annex 1 in the Consultative Document states that "[f]or the interest rate risk factors, "market rates" (and not "zero coupon rates") should be used to construct the risk-free yield curve, consistent with the validation standards and the "use test" set out in Section 4." In other words, sensitivities used for risk factors of GIRR should be "market rates" and not "zero coupon rates". It is however requested to permit the use of "zero coupon rates" or "par rates" prepared based on "market rates", provided that appropriateness is verified by the "use test" for the calculation of sensitivities, taking into account current practice whereby sensitivities are calculated based on rates which each financial institution considers appropriate.

(4) Methodology for calculating capital requirements under the disallowance factor method (Section 2.2.2)

Full netting should be permitted for the sensitivity to the same curve and the same term. If such treatment is not permitted, capital charge would be calculated for basis risk that does not exist.

If the net sensitivity is calculated using the disallowance factor, the calculation outcome may significantly vary depending on the unit the net sensitivity is determined. Therefore, such unit for deriving the net sensitivity should be clarified.

(5) Treatment of "disallowance factor" for FX risk under the standardised approach (Section 2.2, Annex 1 Paragraphs 81-86)

We would like to confirm that the disallowance factor method or the basis risk correlation, an alternative to the disallowance factor method, needs not be implemented for FX risk under the standardised approach because the basis risk does not exist in volatility of FX spot rate.

(6) Setting risk factors under the "correlation method" (Section 2.2.2)

Under the method proposed in this consultative document, increasing the types of risk factors for refinements of measurement of market risk will result in an increase in capital requirements, thereby impairing incentives for banks to take refinement efforts. Accordingly, the types of risk factors to be used for the correlation method should be further clarified; for example, "IBOR (Interbank money market rate)" and "OIS.".

(7) Treatment of "vega risk" under the standardised method (Section 2.4)

For purposes of capturing "vega risk", the identification of risks including smile risk is being considered. While the magnitude of such risks including smile risk is not material, these risks may significantly complicate the calculation of capital requirements. It is therefore requested not to include such risks for calculation under the standardised approach.

Additionally, it is requested to clarify the reason for increasing the factor from 25% in the previous QIS to55% for the vega risk under the standardised approach.

(8) The methodology for calculating curvature risk (Annex 1 Paragraphs 10 and 37)

(i) The description about rho in Paragraph 37 in Page 29 should be deleted. Since parallel shift (or concurrent shift) is assumed in calculating the curvature risk to GIRR, the correlation between grids cannot be used for the calculation. Therefore, the first half of the requirements in Paragraph 37 of Annex 1 is not considered to be meaningful.

(ii) Please clarify the scope of Σ in the formula defining the curvature risk in 10(a) of Annex 1, since it is unclear.

(9) Calculation of sensitivity to credit spread (Annex 1 Paragraph 12)

It is requested to permit a simplified method for calculating sensitivities for credit spread of government bonds, municipal bonds and high-rated short-term bonds.

Since both spread and volatility of these instruments are considered to be small, it is requested to permit firms to apply a simplified calculation method, for example, measuring credit spread risk using a method to multiply a certain factor to the market value of positions.

(10) Treatment of equity risk under the standardised approach (Annex 1, Paragraph 61)

If the calculation logic of equity risk is dependent on the level of FX rates, firms may face a difficulty in risk management practice. Consequently, in determining the size of equity risk, it is requested to permit the home currency-based determination.

(11) Method to aggregate capital charges across buckets under the standardised approach (Annex 1 Paragraph 8 (d))

It is understood that the method to aggregate capital charges across buckets is under discussion because the formula provided in the Consultative Document produces a negative variance. An approach that appropriately reflects the positive/negative of net sensitivity of each bucket should be employed, taking into account an alternative treatment, for example, replacing the current formula $Sb=\Sigma WSk$ with $Sb=\max(\min(\Sigma Wsk,Kb),-Kb)$.

If risk measurement does not appropriately consider the profile of portfolio, the proposed treatment may impede appropriate risk management activities firms should pursuit.

3. Incorporating the risk of market illiquidity in the internal models approach

(1) Scaling of liquidity horizon under the internal models approach (Section 3)

The consultative document proposes to scale at a base liquidity horizon of 10- days under the internal models approach. For highly liquid assets held for trading activities purposes,

established practice across firms is to use the base liquidity horizon of 1 day for risk management activities in general, including loss-cut rules, limit control, and backtesting of risk measurement models. To ensure consistency with these risk management practices, for portfolios with highly liquid risk factors (n=10), it is requested to permit scaling the liquidity horizon to 10 days by calculating expected shortfall at a base liquidity horizon of 1 day.
The above treatment is considered to be reasonable taking into account the ability of disposing assets at the time of historical stressed periods.
If the treatment discussed above is not permitted, firms may face the following issues. Specifically, the Moving Window approach proposed under the fundamental review of the trading book ("FRTB") is generally considered to have an inherent issue in that market volatility for one business day would be used redundantly for the number of days of the holding period. Currently, the FRTB framework proposes to use the most severe 12-month period of stress available over the observation horizon. The number of business days over the 12-month period is approximately 250 days, and hence 97.5% expected shortfall (ES) would be determined on the basis of the top 6 to 7 highest losses (250 x 2.5% = 6.25). On the other hand, under the Moving Window method, since volatility in one business days will be used 10 times, ES would be determined with market volatility only for one day. This method would therefore produce an outcome that considerably deviates from the principle under the FRTB framework "market risk should be measured using a 97.5% ES".

(2) Use of "cascade approach" (Footnote 2 of Box 3 in Page 20)
The cascade approach should be uniformly applied for reflecting liquidity horizon. Footnote 2 in Page 20 is a description based on the methodology for calculating expected shortfall set out in the second consultative document (CP2), and hence should be deleted.

(3) Treatment of liquidity horizon (Paragraph 181 (k) of Box 3 in Page 20)
USD/EUR, USD/GBP, etc. listed in Footnote 3 are generally considered as "liquid currency pairs". Hence, Footnote 3 should be referenced to "FX rate – liquid currency pairs", instead of "FX rate (other currency pairs)." If these relate to "FX rate – liquid currency pairs", and where the liquidity horizon of cross rates against USD listed in Footnote 3 (19 in total) is 10 days, 10-day liquidity horizon should also be applied to other cross rates such as JPY/GBP (171 in total).

4. Other general matters
(1) Sufficient lead time
In implementing the proposed requirements, it is requested to set sufficient lead time, taking into account time required for systems development and other factors.

Since fundamental review of trading accounts would lead to drastic change to current

requirements, it is expected that considerable amount of time needs to be devoted to developing systems and establishing a framework within the firm. In particular, since data currently maintained in the systems could not be leveraged, introduction of new systems and enhancement to legacy systems are necessary for systems development purposes. Therefore, it is requested to allow at least three years as lead time after the publication of the final Accord text.

(2) Use of the term “asset class”

The definition of term “asset class” should be further clarified, because the term “asset class” seems to be used in a different meaning in different sections; for example, “asset class” in Paragraph 8 of Annex 1 and “asset class” in Paragraph 108 of Annex 1.

(3) Definition of “desk”

How the organization is established differs across financial institutions in respective jurisdictions. Since uniform criteria do not suit for defining the “desk”, it is requested to allow each jurisdiction to determine the definition of “desk” at its discretion.

(Reference) Volatility range for Cross-currency basis