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Basel Committee on Banking Supervision
Via E-Mail: baselcommittee@bis.org

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Comments on the Basel Committee’s Consultative Document of 22 July 2008: “Guidelines for Computing Capital for Incremental Risk in the Trading Book”

Dear Sir, Madam,

The Basel Committee on Banking Supervision issued on 22 July 2008 a consultative document entitled “Guidelines for Computing Capital for Incremental Risk in the Trading Book”, inviting feedback by 15 October 2008. We are pleased to take the opportunity to comment and wish to outline the position of the German banking industry in the following.

May we also point out in this connection that we support the ISDA, IIF, LIBA and IBFed response to the Basel Committee’s paper.

1. General remarks

Against the backdrop of the ongoing financial market turmoil, we can in principle understand that supervisors are seeking to introduce higher capital requirements for the trading book. Capital requirements should, however, be in line with the risks which will be incurred by

institutions in the future. In our opinion, the market turbulence witnessed in the course of the subprime crisis during the past few months does not justify excessive capital charges. The banking industry has already made considerable efforts in many areas of internal risk management to adequately address the causes and effects of the financial market crisis. We believe that a modified approach geared to the individual situation of an institution offers clear advantages over higher capital charges prescribed by supervisors.

In addition, an alignment must be ensured between the internal models used by institutions in the future and supervisory requirements (use test). Particularly in the area of measuring incremental risk, in which there are not yet any market standards, the future development of internal models must not be restricted by rigid supervisory rules. Institutions implement risk models mainly because these are geared more flexibly and appropriately to their individual risk exposure and portfolio structure. Rigid supervisory modelling rules that are predominantly conservative cancel out the benefits of an institution-specific model. This greatly reduces the incentive for risk management based on an internal model.

Due to the differences between previous risk models and the IRC model, particularly with respect to the different model parameters, we have considerable doubts as to whether it will be possible to integrate different risk models into a unified internal management control system (use test).

Banking industry estimates show that the proposed supervisory rules on incremental risk modelling will lead to an enormous increase in the capital requirements for the trading book. Such an increase will have side-effects. Compared with the incremental risk charge (IRC), the short-term VaR for market risk (10 trading days, 99% confidence level) will only make a relatively minor contribution to total capital requirements. This means that the supervisory significance of the short-term VaR for the calculation of capital requirements will be considerably weakened. Furthermore, the capital-based incentive to switch from the market risk standardised approach to internal models will be diminished or actually eliminated by the higher capital requirements for the latter.

Because of the remaining technical weaknesses of the present incremental risk modelling guidelines, which in our view have been insufficiently thought through, institutions should be given the option of using a simpler method. Moreover, the planned two-stage implementation period for risk modelling is extremely ambitious.

A conceivable approach would be to define a supervisory scaling factor. The envisaged increase in capital requirements could be achieved by multiplying an institution's individual VaR by the scaling factor. Allowing institutions the alternative of using a simpler method would also give them time to adjust their processes and methodologies.

The proposed IRC implementation period means that there is no time for the necessary quantitative impact study (QIS), whose results could be taken into account when finalising the guidelines. Nor will it be possible within the proposed timeframe for institutions to ensure that risk calculations and risk management are of a satisfactory quality. Much more time is needed to develop adequate market standards in the area of incremental risk. The implementation period for institutions which will first switch to supervisory recognition of internal market risk modelling is unclear. Such institutions must not be discriminated against. To ensure that the development and implementation of models are of adequate quality, the period allowed for implementation should be extended to the beginning of 2011 at least.

2. Specific remarks

IRC-covered positions and risks

Paragraph 12:

It is unclear why the scope has been extended to risks that were deemed in the new framework to be general market risks (such as risks from equity indices) and why the new charge is not restricted to specific risk. The guidelines should be restricted to specific risk modelling standards. The double-counting problem could then be reduced, any devaluation of the traditional short-horizon VaR approach diminished and user acceptance of the new models ensured.

We assume that the IRC is only to be taken into consideration for those trading products that are already the subject of internal bank modelling. In principle, the main focus should be on a risk's significance. The individual configuration of a bank's trading portfolio must be allowed for in an appropriate way. Furthermore not all risks can be satisfactorily modelled; for instance, the accuracy of an estimate cannot be fully guaranteed if certain market data is missing. A blanket expansion of the scope to so-called "non-IRC market factors" contradicts the idea of the incremental charge, increases the model's complexity still further, devalues the 10-day VaR and should therefore be rejected.

Constant level of risk over one-year capital horizon

Paragraph 20 (footnote 3):

We continue to hold the view that citing the banking book rules in Basel II as a reference point and justification for selecting a one-year capital horizon and 99.9% confidence level is unacceptable and incompatible with the situation in a trading environment. This criticism is now given even more weight by the fact that the scope of the IRC has been extended considerably and covers many more risks. In particular, the assumption of a constant level of risk over a one-year capital horizon for liquid equity positions is unrealistic and unjustified in our view. For economic risk management purposes, institutions use risk management strategies which are at odds with the “constant level of risk over a one-year capital horizon” assumption. These internal strategies should be included in calculation of capital requirements. The possibility to include such risk management strategies would make the IRC much more risk-adequate and also provide incentives to enhance risk management.

Liquidity horizon

Paragraph 25:

Institutions themselves should be responsible for defining the appropriate liquidity horizons for each position. The Basel Committee should allow flexibility as long as the trading and risk management practices of the institution are consistent with such definitions. Imposing floors on broadly defined asset classes may severely distort a proper reflection of different markets (e.g. related to highly liquid equity indices or less liquid single stocks). Inappropriate liquidity horizons may also lead to a misrepresentation of hedges (e.g. hedges with shorter maturities than the imposed liquidity horizon) and consequently lead to an undue capital charge.

In particular, long, fixed liquidation horizons can significantly distort the representation of option positions that are typically rebalanced in short to medium timeframes with liquid instruments (e.g. exchange-traded options). A position with a long gamma profile would receive an artificially low, and a position with a short gamma profile an artificially high risk charge, as very large market moves (without re-hedging occurring) are assumed.

The required classification of trading products places great demands on internal implementation, in particular with regard to technical and processing solutions and the functional differentiation between individual asset classes. For this reason, the banks should at

least be permitted to apply a single liquidity horizon to all trading products. However, the floor for all trading products should be the shortest time horizon rather than, as has been suggested, the longest. If a trading product requires a longer holding period, this could be increased.

Concentration

Paragraph 30:

There is still very little research on the modelling of correlations under different market conditions and on their stylised facts. At this stage, the introduction of varying correlations into the IRC model framework would most probably have an adverse effect on the statistical soundness of the figures generated. This would undermine not only the soundness of the IRC in its function as a supervisory risk capital measure but also its acceptance for internal risk management purposes.

Double-counting

Paragraph 36:

The method proposed in the consultative document for modelling incremental risk – no separation of general market risk factors and specific risk factors – leads to double-counting. Double-counting results in over-estimation of risks, which considerably diminishes the usability and acceptance of the IRC model as an internal management tool. If the weakness of the double-counting approach – the overlapping of risks – is not removed, institutions should at least be allowed to reduce double-counting by making individual adjustments. However, it is anticipated that this type of correction will only be possible as an approximate adjustment across the board. Both with a fundamental conceptual overlap and also with such “rule of thumb” adjustments, the applicability and acceptance of the IRC will be further limited.

Validation

Paragraph 39:

It is unclear how validation of IRC models for a one-year horizon and a 99.9% confidence level can be carried out. Validation by means of backtesting is only possible if a shorter time horizon and/or a lower confidence level are set. The supervisory rules on validation are unhelpful in our opinion and merely restrict institutions’ room for manoeuvre. It should be left

first and foremost to institutions to conduct adequate validation. Only once market standards on incremental risk modelling have evolved can detailed supervisory validation standards be set.

We reject any supervisory “model portfolio” requirement, as such a model portfolio in no way reflects the special features of an institution-specific trading portfolio. The benefits of validation by means of a model portfolio would not be in proportion to the heavy implementation burden (market data, valuation models, etc.).

Frequency of calculation

Paragraph 45:

The model parameters, especially the assumption of a constant level of risk over a one-year capital horizon, are a disproportionately long period of time for traded products. In contrast, the given calculation cycle of one week for IRC is very short. A one-week calculation cycle disproportionately increases internal costs for the validation and analysis of the results. The period is also too short to implement the IRC calculations and for the banks to check both their database in advance as well as the subsequent results. The period of time for credit risk monitoring should be the same as that for the other cycles. The calculation cycle should therefore be one month.

Interim charge

Paragraph 50:

Due to the considerable time constraints and technical objections, we reject the interim solution proposed for re-securitisations. The significant effort required to implement an interim solution is not justifiable in our view. Rather than implementing such a short-term solution, institutions should focus on enhancing incremental risk modelling for these positions. We do not believe that there will be enough time for institutions to adapt the securitisation banking book approach to specific securitisation trading book positions. Different processes and risk management principles need to be taken into account for trading book and banking book positions, making any short-term adjustment particularly challenging. With many of the details yet to be decided, we suggest that the switch to the new rules at the beginning of 2009 be reconsidered. Much of the work involved will depend on the scope and extent of positions to be included under the interim solution and the final definition of “re-securitisation”.

Disclosure

Paragraph 51:

When switching to the new supervisory environment for the first time, its impact on capital requirements due to the jump in level associated with it will certainly have to be explained. We do not, however, see any need for permanent additional disclosure requirements compared with the old regime.

Should you have any questions or require any further clarification of the above points, please do not hesitate to contact us.

Yours sincerely

on behalf of the Zentraler Kreditausschuss,

Bundesverband deutscher Banken



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