FÉDÉRATION BANCAIRE FRANÇAISE

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FBF RESPONSE TO EUROPEAN COMMISSION'S CONSULTATION PAPER ON PROPORTIONALITY IN THE FUTURE MARKET RISK CAPITAL REQUIREMENTS AND THE REVIEW OF THE ORIGINAL EXPOSURE METHOD

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The FBF welcomes the opportunity to comment on the European Commission's Consultation on proportionality in the future market risk capital requirements and the review of the original exposure method. In January the Basel Committee on Banking Supervision released its revised rules on trading book capital requirements. These emerged after three consultations aimed at improving the existing market risk capital rules that were introduced in the wake of the global financial crisis by 'Basel 2.5'.

While the FBF was supportive of the introduction of a consistent framework on market risk, the FBF is concerned that the EC is already seeking to transpose the final outcome of the Fundamental Review of the Trading Book (FRTB) in the EU legislation, and that the current consultation is only focused on proportionality whereas many areas of the new framework would need to be clarified beforehand. The paragraphs below do not aim at providing exhaustive comments on the new market risk framework as specified in Basel but merely seek to underline a few of the key issues and challenges that would arise from proposals tabled before the end of 2016.

1. The new market risk requirement, as currently specified in Basel, would induce significant increase in capital requirements for banks

We understood the objectives of the Basel Committee of improving some shortcomings of the Basel 2.5 framework (currently in force with CRR in the EU), and without "significantly" increase the overall capital requirements for market risk, but rather propose a reallocation of capital between different asset classes.

As a matter of fact the Basel 2.5 reform led to an average increase for banks of more than 220% of capital requirements for market risk (according to the Basel Committee), which was at that time already a huge augmentation. With the new market risk regime, aiming at completing the post-crisis Basel III reforms, the Basel Committee announced an “approximate” median increase of 22% and a “weighted” average increase of 40% in total market risk capital requirements. Moreover the Basel Committee announced that market risk capital charges under the revised standardised approach (SBA) are 1,4 times those of the revised internal models approach (IMA) for the median bank.

This is probably underestimated because the framework has been calibrated upon a QIS that was not reliable enough as shortcuts were taken by the Basel Committee when insufficient or non-viable data were provided by QIS participants that led it to take arbitrary assumptions to correct the data. Moreover it appeared that some data perceived as “outliers” may have been modified to comply with peer’s group without consultation nor justification.

Before any implementation and with the view of properly understanding the impact on the wider economy, the FBF respectfully asks that an exhaustive and granular impact analysis be conducted, i.e. on the basis of the relevant data provided by European banks and asset class by asset class. It should also be underlined that markets and markets participants are currently impacted by several major new regulations, such as mandatory clearing and bilateral margins, and by a very specific monetary environment; from this perspective, we would also recommend that the impact assessment be made not at a point in time but on an ongoing basis, i.e. reiterated in the future in order to capture potential structural evolutions.

2. The calibration of a floor is still under discussion at Basel

The FRTB is part of the ongoing thoughts and works in Basel whose purpose is to review all current standardised methods (market, operational, and credit risk) in order for them to act as credible floors to internal models (IRB and IMA).

The new standardised method (SBA), which is more risk sensitive that the current standardised approach, will be mandatory for all banks even for those who will be approved for using IMA at desk level.

The calibration of the market risk floor (if any) is still under discussion at Basel and will also depend upon the outcome of the calibration of the credit risk floor.

It is worth noting that the rationale for a floor is not clear in a context where qualification tests enabling a firm to use the IMA (backtesting and P&L attribution) are performed at the desks level and are particularly demanding.

The effect of a market risk floor on capital requirements could be massive if calibrated too high (eg between 60% and 90%) and could divert banks to develop risk-sensitive internal models because it will amplify the overall capital requirements already increased with the change-over from Basel 2.5 to the new regime. In addition, as the EC is well aware, there are multiple other approaches to reduce RWA variance among firms.

The FBF respectfully asks the EC to support risk sensitive approaches in Basel, to proactively engage in order not to introduce a floor in the Basel market risk framework and consequently, to avoid the inclusion of such floor in the European Market risk proposals.

3. <u>There remains a number of issues where further clarification is needed</u>

There is significant industry concern that the new regime has been over-calibrated, with unduly penal effects on market risk capital and market liquidity.
Besides a number of challenges are still to be considered, notably how they will source appropriate data for the required daily fair-valuing of positions through the P&L statement, how desk level model approval should be managed and, importantly for the traders on those desks, P&L attribution test.

Another key issue is the extent to which larger banks really will be able to choose between the IMA, which will require pre-regulatory approval, or the fall back approach (SBA) which is designed for banks with more limited trading book activity. Some banks may feel that with all the expense that developing and maintaining an IMA entails the expected capital saving is just not worth the cost of the modelling candle. But will regulators allow large, more internationally active banks to exercise this rational choice or apply moral suasion to encourage them to use the revised IMA?

The FBF considers that all these issues need to be analysed and discussed with the industry beforehand in advance of any EU implementation. A very well prepared text could lead to postpone the proposals in 2017 but would avoid a lot of misunderstandings and would save a lot of time during the negotiations process between Member States and with the European Parliament.

4. <u>We question the potential timeline</u>

Given that the new regime was scheduled to enter into force as soon as the beginning of 2019, banks have already started preparing for implementation as this will be a challenging reform, from all standpoints (banks and supervisors): interpretation/ guidance, modelling, IT infrastructure and capacity, desks definition, data quality, … . However:

- The deadline for first publication may look far (last day of 2019) but looking backward, as one year of data is needed for back-testing and the homologation process may take a long time (one year seems quite an optimistic guess, having in mind the number of models to be approved and the level of details, internal and external supervisors will seek in order to be able to review the models) overall banks would in practice need to be ready by the end of 2017. While guidance will be sought on many computation aspects, that sourcing data could rely on industry utilities that do not yet exist (…), such a timeline does not seem realistic. If the final answer to the Q&A which are expected soon were to be still very much unclear, it would be impossible to deliver the IT development with such unknowns in the process.
- The P&L attribution test raises a lot of questions and challenges that would also deserve some kind of progressive approach.

- Also, given the forecasted impact on some business lines, such short time-lapse won't give the time for the business model to adapt without going through major restructuring.
- The homologation process by the supervisors is also a source of concern. There are a lot a desks/banks to go through and it is a worry for everyone that all the desks that should be homologated by 2019 are fairly treated on an equal footing between the banks. It is crucial that supervisors are granted enough time to approve the models and that in the meantime, banks are not forced to use the (penalising) SBA: once models have been submitted and until they have been approved, they should be deemed approved until formally rejected.

The Commission should postpone the entry into force of the FRTB, considering the material operational challenge the reform induces, back testing requirements and supervisory review and validation.

Bearing in mind the number of operational, technical and theoretical questions that are pending, the major reforms that the teams went through to date (leading to a form of "fatigue" and stress in all areas) and the detrimental impacts on the trading activities in Europe and on the wider economy if the framework is not properly specified and calibrated, we would respectfully urge the Commission to carefully consider engaging a wide consultation before tabling its "FRTB proposals" and not to "front run" the new market risk framework implementation but rather to consider a safer entry at a later stage than what was contemplated in the Basel text.
In summary, a postponed one year parallel run starting not before 2020, with a full entry into force at least 15 months after the start of the parallel run would have several merits:

- this proposal aligns with EBA draft model submission guidelines including parallel run requirements for which there is no direction in the Basel text;
- it would give banks sufficient time to organize external and internal data, models, systems, and IT and risk infrastructures, and possibly for external utilities to offer a service for smaller banks;
- it would also allow end users and bank time to adjust to new pricing norms reducing stability impacts;
- it would enable for review of completely untested elements of the framework, such as P&L attribution, which could otherwise threaten market dislocation;
- it would also ease capacity issues which will arise with desk by desk model reviews by regulators.

5. Discussions on simplified approach for small trading books seem to be re-opened at Basel
Accordingly it does not seem desirable of pre-empting current discussions at the Basel Committee.

Please find hereafter our answers to questions related to the consultation.

1. Can the new standardised approach in the BCBS FRTB framework be easily applied to all institutions with a trading book? If not, which elements of this approach would be more challenging to implement and for which types of trading books? If possible, please provide a quantification of potential implementation costs for the institution concerned.

The FBF believes that the Sensitivity Based Approach ("SBA"), as adopted by the Basel Committee, is in line with industry recommendations on leveraging upon existing validated risk metrics to calculate the market risk capital requirements. The initial Basel proposal of an Advanced Cash Flow Approach ("ACFA") methodology was not computationally supported by existing infrastructures, and would have required industry members extensive resources to adhere to currently regulatory timelines whilst achieving little in terms of enhancing the risk sensitivity of output metrics. The AFCA would have been particularly onerous for smaller organizations.

The use of existing validated risk metrics that are universally used by industry members, allows for consistency and comparability while at the same time avoids unnecessary operational complexity that is bound to impact the implementation timeline. Worthwhile noting that the QIS on SBA may exhibit some volatility in the results across banks but it would be mainly the consequence of some differing interpretation of the text where it lacks clarity. In addition, the risk sensitivities that form the basis of the SBA are used widely across the industry as an integral part of the risk management framework not only in the larger institutions but within smaller banks. There are numerous vendors and applications available to the industry participants which could mitigate significantly the implementation burden especially for smaller organizations even if they do not currently utilize risk sensitivity metrics. This is in diametric contradiction to the operational complexity faced by a less complex institution that would have needed to implement the ACFA.

2. In case the new BCBS standardised approach from Basel is not considered an adequate framework for all institutions with a trading book, which of the following three alternatives would be considered the most appropriate framework to deal with smaller or simpler trading books and why?

a. The current treatment under the derogation for small trading books with increased thresholds and potentially the necessary clarifications and reviews described above;

b. a simpler standardised approach;

c. a combination of the former two elements with potentially two different thresholds.

Please, also specify, for the alternative chosen, which considerations have to be taken into account to re-calibrate the level of the threshold(s) and the appropriate calibration of the threshold(s).

From our perspective, a certain degree of complexity in the standard approach design is unavoidable. A right balance between simplicity and complexity is highly desirable while pursuing the unique goal of simplicity could instead result in inappropriate risk pricing.

In addition, the supervisor has to ensure that banking institutions operate on a level playing field, and our fear is that this may not be guaranteed anymore if introducing proportionality considerations. We do agree that market risk is not only to be considered through the size of a portfolio but also through the complexity of its positions/instruments.

One of the reasons put forward by the Basel Committee not to rely on sensitivities within the standardized method framework is that in some jurisdictions, some banks may find it difficult to produce sensitivities.

However the current standardized approach could be kept available for those banks with business models that do not require sophisticated measurement methods, but only if the proportionality benefits equally to all banking institutions. Therefore, for consolidated groups, not only should the option exist at the level of their small banking entities but also when proceeding to the aggregation at the Group level (otherwise, small banks within a consolidated group will be forced to implement sophisticated methods for aggregation purpose only). This framework would benefit to all institutions without jeopardizing the simplicity/risk sensitivity objective sought by the Committee:

- Less sophisticated institutions with very limited trading activities would not be obliged to engage into tremendous implementation costs and could keep on relying on less risk sensitive though more conservative and well-mastered methodologies;
- The constraint of no reliance on basic sensitivities on the ground some institutions are unable to compute them would be lifted. As a result, other institutions could leverage on existing risk metrics like basic risk sensitivities (PV01, CS01) provided their definitions meet the Basel Committee requirements.

From this perspective, an alternative approach would be to encourage smaller banks to create a utility to which they could delegate the computation of their relevant risk metrics; this utility could be supervised by the ECB or other NCAs and would be the prior contact point for all methodology issues. This utility could potentially also provide support for the IMA, depending on allocated resource and supervisor approval.

3. In case option b) or c) have been chosen, which of these two possibilities would be considered the most appropriate regime for institutions with smaller or simpler trading books;

a. a simplified version of the new standardised approach, to be developed; or

b. the current standardised approach?

Please, justify your answer from a cost-benefit perspective. If a) is chosen, please specify which simplifications to the FRTB standardised approach would need to be performed.

In this case we would be in favour of option a, however considering ongoing discussions at Basel we recommend the Commission not to pre-empt the potential outcome of these ones.

4. Please, indicate which of the two conditions provided in Article 94 of the CRR is currently more constraining for your institution, supporting your answer with data reflecting the evolution of total trading exposures in balance sheet.

We do not have any comments.

5. Besides the level of the thresholds, do you agree with the previous analysis on the other elements of the derogation for small trading book business? Which ones would need to be addressed and how?

a. The definition of the thresholds, making them more specific and harmonized as described above

b. the clarifications on the application of the credit risk framework to some trading exposures, especially derivatives; and/or

In the case of item b) please specify which clarifications/modifications would be necessary and for which trading exposures in particular. In the case of changes to a) and b), please provide some measures of quantitative impact of the modifications proposed on your institutions.

We do not have any comments.

6. For those institutions that currently use the OEM, do you see any merits in replacing the OEM with the SA-CCR in the prudential framework? Would the operational difficulty to implement SA-CCR be the only impediment for your institution to the replacement of OEM by SA-CCR? Would your derivative activities be negatively impacted by the introduction of SA-CCR due to the impact of the replacement of OEM by SA-CCR on the risk-based capital requirements and leverage ratio requirement?

The Basel Committee SA-CCR framework is a much more risk sensitive approach than the current non-internal model approaches for credit and counterparty risk. However, we found no evidence of any upside in implementing this methodology for smaller banks, with small or simple portfolios. Indeed, for institutions that use the Original Exposure Method (OEM) the total derivatives and counterparty risk exposure is not significant anyway. Moreover, the risk profile of smaller banks with mainly vanilla portfolios may not justify the implementation of the SA-CCR method either. As the SA-CCR is significantly more complex its implementation would be very challenging for smaller banks, and at a very high cost, while the differences on the own funds requirements for such banks would be insignificant. Therefore those institutions should have the possibility to maintain the existing framework.

We are thus truly convinced of the need to introduce proportionality aspects in the way the SA-CCR would be implemented within the European regulation, especially when the bank doesn't carry significant derivatives or counterparty risk (either by the size and/or the nature of its portfolio).

From a more general perspective, since the SA-CCR framework requires considerably more input data and considering the numerous other on-going regulatory initiatives relating to counterparty risk (such as EMIR's mandatory clearing, margin requirements for non-centrally cleared derivatives, revisions to the CVA framework etc.) we are very concerned that the supervisor allow sufficient time for implementation following the publication of a final EU regulation; implementation efforts and IT infrastructure challenges should indeed not be underestimated.

7. For those institutions that see no merits in replacing the OEM with the SA-CCR, do you find it appropriate to keep the OEM in its current form, including its link to the derogation for small trading book business, its specific use for the calculating the leverage ratio and the CVA charge? If not, please explain what you would like to change in the current application of the OEM under the CRR and why. In addition, would you find it relevant to develop some limited modifications to the OEM to ensure that it is more consistent with the SA-CCR (while avoiding undue increases to the complexity of the OEM)? If yes, which modifications would you propose to the OEM to be more consistent with SA-CCR?

We do not think appropriate to review the OEM, should it be kept for smaller trading books.

8. For those institutions that currently use either the MtM Method or the SM, do you see any merits in replacing these approaches with the SA-CCR in the prudential framework? Would the operational difficulty to implement SA-CCR be the only impediment for your institution to the replacement of these approaches by SA-CCR? Would your derivative activities be negatively impacted by the introduction of SA-CCR due to the impact of the replacement of these approaches by SA-CCR on the risk-based capital requirements and leverage ratio requirement?

First of all we think that before any implementation of the new SA-CCR, the Commission should carefully assess the potential impact in terms of capital requirements for European Banks. Indeed, despite the embedded improvements, SA-CCR introduction can have dramatic impacts on EAD assessment. In particular, the upward revision of add-ons, the lack of recognition of cross-asset diversification, and mostly the use of an alpha multiplier of 1.4 which scales EAD up by 40% bringing significant impacts on EAD for a large range of portfolios make SA-CCR overly conservative. Furthermore the combined effect of SA-CCR with the CVA risk current standardized approach and forthcoming FRTB-CVA basic approach imply even higher capital requirements. For these reasons, we firmly warn that SA-CCR will have a significant impact on transaction ROE, from which we expect implications on banks' business models, affecting client pricing and potentially corporate participation in the derivatives market.

In addition, for the SA-CCR implementation, the Commission should consider the undesirable impacts (alpha, IM and VM) on both the leverage ratio and large exposure monitoring, where the intent is respectively to measure the propensity for firm and systemic leverage and the propensity for concentration.