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Dear Derek, Simon

Joint Trade Associations’ Response  
FSA DP 10/04: The prudential regime for trading activities

Introduction
The Association for Financial Markets in Europe (AFME), the International Swaps and Derivatives Association (ISDA) and the British Bankers’ Association (BBA) (jointly ‘the associations’) are pleased to respond to FSA DP 10/4 – The prudential regime for trading activities: A fundamental review.

This response is split into two sections:

1. Key messages
2. Answers to Questions

1. Key Messages
The Associations’ Members have identified the following key issues from this discussion paper:
We welcome the decision of the Basel Committee to undertake a fundamental review of the trading activities and the FSA’s decision to highlight its preliminary thinking in this area. As the Discussion paper indicates, the existing trading book regime has been the subject of numerous iterations but has not had a fundamental review since inception.
The regime has also been severely tested during the crisis. We therefore welcome this opportunity to contribute to the debate.

As we consider the prudential regime for trading activities to be an important component of the prudential framework and therefore contributing to enhanced financial stability, we think that it is vital that the review is undertaken thoroughly. To that end, while we acknowledge the importance of learning the lessons from the crisis, both negative and positive, it is vital that the review is fundamental in nature, incorporating an analysis from first principles. We are concerned that the DP does not include a market failure analysis and concentrates on the negative experiences learned from the crisis, while not sufficiently exploring the experiences of those who came out of it successfully.

In our view the key pre-requisites for the review to be successful are as follows:

- **A clear articulation of the soundness standard being sought for the capital framework.** We do not think that this necessarily has to be set in terms of a confidence level for modelling, but it does need to be unambiguously expressed so that firms understand what is expected.

- **A clear articulation of the purpose and role of the various elements of the regulatory framework.** The introduction of regulatory buffers and the absence of discussion of Pillar 2 in recent regulatory pronouncements has meant that firms are no longer clear as to the function of the various elements of the regulatory framework. Not only does the relationship between the pillars need to be addressed but the relationship between macro and micro-prudential regulation, including any additional layers imposed on systemically important financial institutions, must also be considered.

- **The interaction of any changes considered with the changes to the broader framework that has been agreed needs to be fully assessed.** Quantitative impact studies and broader economic impacts are essential steps to help ensure that unintended consequences are firstly understood and secondly addressed. These studies should not be rushed and should be developed in conjunction with the industry so that all parties understand what is being sought and high quality data can be produced to support the analysis. This work is particularly important since any change to the current trading book boundary will have consequences for other elements of the capital framework, both in terms of scope and treatment, which may require one or other to be revisited.

- **A close and continuous dialogue between the regulators and the industry is needed.** Greater understanding of the regulatory outcomes sought will help the industry to assist the regulatory community in developing a sound, robust set of requirements that can be applied by all.

- **A sensible timeframe for the review should be set.** In order to undertake analysis from first principles, an appropriate amount of time should be allotted to the review. We are concerned that the proposed timetable, which suggests completion by the end of 2011, is too quick and would urge the FSA and their regulatory colleagues not to rush this process. This is a unique opportunity to
create a coherent regulatory framework and we do not think that the review should be constrained by unrealistic deadlines.

- **International agreement is essential.** Although we appreciate the opportunity to understand and comment on the FSA's current thinking, for any revised regime to be successful it needs to be agreed at the international level and implemented in a convergent manner.

In order for the review to be truly fundamental we think that a market failure analysis should be undertaken. Although we accept that some of the tenets of the economic framework upon which it is based have been challenged by recent events, we continue to believe that it provides a useful framework for thinking and will help to inform the options to be considered by anchoring the analysis to a clear set of objectives.

In addition we think that there are a number of key principles that should be borne in mind when developing the proposals for revising the prudential framework:

**Appropriateness** – There must be a sufficiently close and credible link between the requirements and the regulatory objectives. Within this overarching principle we think that the following should be borne in mind:

- The regime should be **risk sensitive** and therefore provide incentives for positive behaviours by firms. Risk sensitivity also encourages the development of risk measurement and management practices. It should be assessed both within and between risk classes so that the framework provides a level playing field within and between different risk types. Moreover, hedging, or mitigating risks should be encouraged by the framework. Appropriate capital requirement either side of any trading book/banking book boundary, if one is deemed appropriate, and the approach taken to deciding where the burden of proof lies should mitigate concerns relating to arbitrage.

- The **risk management strategy** that is adopted is relevant to the determination of capital required. The capital framework should reward the degree of effective risk management.

- The framework should be **forward looking.** Forward looking does not necessarily mean that Pillar 1 needs to be calibrated to the bottom of the cycle.

- **Capital is not always the right solution** to supervisory concerns.

- Once a soundness threshold has been articulated, the purpose of capital should be to **support unexpected losses** up to that threshold which can arise as a result of following the risk management strategy. Expected losses if any should be supported by provisions.

- The framework should capture the **material risk drivers.** In this regard we think that there should be consideration of whether **risk liquidity** is one of those drivers. Risk liquidity reflects the ability to hedge or unwind risk in the market. The risk liquidity horizon is the time it would take to unwind a position or effectively hedge it.

- The regime should be **flexible** enough to allow for market, product and risk management developments. Therefore an appropriate balance needs to be
struck between detailed rules and principles. While some detail will inevitably be necessary, it is important not to make the rules so prescriptive that they need constant readjustment. It is also necessary to recognise that firms are different and one size does not fit all.

- The framework **should not confuse consistency of outcome sought with consistency of approach.** Requiring firms to adopt exactly the same approaches will create herding behaviour, exacerbate procyclicality, and can create systemic risks.

- **Sound financial models, supported by appropriate controls, are the most accurate way of measuring risk and should be part of the framework.** We accept that no model is ever perfect; it is the result of certain assumptions and trade-offs and therefore has limitations. However, provided those limitations are understood, by both firms and supervisors, models provide a sound basis for risk management and capital requirements. For models to be an effective tool within the regulatory framework it is necessary that the soundness standard set is such that firms are able to perform appropriate validation. If greater conservatism is required it should be achieved through other means than setting unachievable soundness standards that cannot be validated.

- The framework needs to create a **coherent whole with other parts of the regulatory architecture**

**Proportionality** – The rules should impose the smallest possible cost or burden consistent with achieving the regulatory objectives and should not unduly penalise one sector of the market over another. Within this principle we think that the following should be borne in mind:

- **Approaches addressing different levels of sophistication** should be available so that the framework can be applied to the full range of participants in the market.

- Minimum capital requirements should seek to **address all the material risk drivers**, but should not attempt to address all conceivable risks to ensure that the requirements meet cost benefit considerations.

- The requirements should **make use, as far as possible, of the practices that firms already use.** In particular, as noted above, this would include the use of modelling. Additionally exposure value should be assessed by reference to accounting (as this determines how banks value their positions and assess their performance). We urge the FSA to support and encourage accounting convergence based on standards that reflect business strategy and accurate earning recognition while permitting prudent provisioning.

- **Double counting should be avoided.** It is important that the framework seeks to eliminate double counting of risks. In this regard the interplay with the accounting also needs to be considered.

- There should continue to be a differentiation between more and less sophisticated capital requirement setting techniques to help ensure that there **continues to be appropriate incentives for improvement.**
Regulatory requirements should be **clear and transparently applied**.

- **Outcomes sought should be clearly articulated.**
- **Undue complexity should be avoided.** That is not to say that the simplest answer is always the best. Simplistic rules have their place within the framework, but so do more sophisticated techniques; a balance needs to be struck.

## 2 Answers to questions

**Chapter 2- Interactions with other proposals**

**Q1: Are the most important interactions with a fundamental review of prudential requirements for trading activities covered in this chapter? If not what other key interactions need to be considered?**

We agree that the chapter identifies the majority of the interactions that need to be taken into account in developing the fundamental review of trading activities. However, the interactions between the various developments to the framework to date are difficult to determine and will require very careful consideration.

The key issues that are not addressed in this chapter, but which, in our view, are essential to an effective outcome from the review are the need:

- To articulate a soundness standard of the framework;
- To articulate the purpose of the various elements of the prudential framework (Pillar 1, 2 etc);
- For the review to ensure that material risks are capitalised up to, but not beyond, the soundness standard;
- For the review to be undertaken over a sensible timeframe and to include extensive calibration studies;
- For an appropriate balance to be struck between detailed rules and principles.

In respect of the timeframe we note that in the recent report of the Basel Committee on Banking Supervision to the G20 it suggests that the work on the fundamental review will be completed by the end of 2011. Given the current changes that are underway, and which will take some years to implement, we think that this review should not be rushed. It is important that the interactions between new elements of the framework and any changes to the current trading book regime are fully assessed and understood.

We think that the review needs to consider the balance between detailed requirements and principles. In order to retain sufficient flexibility to address evolving market conditions, risk management techniques, and product and other developments, we think that the balance should be tipped towards principles focussing on the outcome sought, rather than the method by which it is attained. Such an approach would not only resolve the need to update the rules with each new development, but also limit the risk of systemic risks being created by forcing all firms to follow a single approach. We
accept that a certain level of detail will be necessary and that a more principles based approach poses its own challenges in terms of delivering a level playing field, but we think that appropriate supervisory co-ordination, combined with the enhanced supervision envisaged by the FSB, should provide a sound basis for proceeding.

We are also concerned by the apparent degree to which the DP10/4 appears to be trying to address macro-prudential issues within the micro-prudential framework rather than addressing them separately as part of the discussions on the macro-prudential toolkit and how it might be used. This is a particular issue in relation to the comments on credit markets, where the DP indicates that because less credit risk is taken by non-banking entities than in other areas a differential approach should be taken to cover the fact that risk remains in the banking system. It is important to distinguish between micro-prudential regulation and macro-prudential regulation (which may use micro-prudential tools). The hedging activity undertaken by firms at the micro-level should be recognised in the micro-prudential rules. The potential build up of a risk in the banking system is a macro-prudential issue and should be handled separately. We would like to see further articulation of how macro-prudential supervision is intended to operate and would urge that macro-prudential regulation should be considered a separate overlay.

One other aspect that is touched upon in Box 2.1, but not commented on separately is the need for an internationally agreed approach. If the UK, or Europe, agrees a different standard or approach to that in other major jurisdictions, then trading activities may be driven elsewhere. This would be an undesirable outcome that should be avoided. We would also be concerned if the FSA were to move ahead of international agreement in any of the areas discussed, as in our view this would represent unnecessary gold-plating that would run counter, in Europe, to the concept of a single rule book (for example the comment in paragraph 7.56 that the FSA intends to issue a further DP on Interest Rate Risk in the Banking Book (IRRBB)).

‘Recovery and resolution’ planning, and the ability to resolve will play an important part in the reform of the financial system. However, we would caution against imposing structural changes (such as splitting investment banking activity from retail banking or imposing subsidiarisation).

We are supportive of capital and liquidity reform as a means of strengthening the financial system provided that it is proportionate and retains a risk based approach. In our view, there remain a significant number of unanswered questions regarding the Basel 3/CRD 4 package that need to be addressed before it is possible to determine the residual risks to regulatory objectives in relation to trading activities. In relation to procyclicality, and as noted in the AFME/ISDA response to the Commission consultation on countercyclical buffers the extent to which the current, and amended, framework is procyclical is currently unknown1. Whilst we would agree that excessive procyclicality in the framework is undesirable, we believe that a degree of procyclicality is acceptable and therefore remain supportive of risk sensitive approaches in Pillar 1.

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1 The European Commission's report to the Council and the European Parliament 'On the effects of Directive/EC and 2006/49/EC on the economic cycle'
Finally it is vital that unintended consequences of any proposed changes are captured. Therefore calibration has to be approached carefully and we would like to work with the regulators on the development of QIS exercises at an early stage. A clear understanding of what is being sought will help firms complete the data requests. Sufficient time also needs to be built in to the process to allow firms to collect data necessary and undertake sufficient checks to deliver robust information.

Chapter 3 – The current framework for trading activities

We note the commentary around the apparent flaws of the current trading book boundary and agree that the boundary is a valid area for review. However it should be borne in mind that any alteration would impact other parts of the capital framework, both in terms of the risks that should be covered and also how they are treated. Unrecognised losses arising from firms’ non-fair valued assets also eroded inter-bank confidence and therefore also suggest that the banking book should not be ignored. Our thoughts on the boundary are contained in our response to question 13.

Chapter 4 – The evolution of traded markets

We note the commentary with respect to the structure of traded markets and whether credit is different. However, we would highlight that it has traditionally been the role of banks to provide maturity transformation, thereby taking on liquidity and credit risks. While credit risk may have stayed largely in the banking system, in volume terms, the introduction of new tools to trade credit, combined with the incentive structure provided by the capital framework has altered the nature of the risks retained, with a bias toward higher quality. We acknowledge that losses suffered by some institutions in relation to the risk retained were a result of inaccurate risk assessment as well as an absence of market liquidity and as noted in previous responses, we support appropriate enhancements to the framework. We would also note that the fact that credit risk is largely retained within the banking sector is not necessarily a bad outcome, since it is within the regulatory purview.

Chapter 5 – Lessons from the Crisis

Q2: Do you agree that the issues described above are the key issues that should be addressed in the fundamental review? If not, what other issues should also be addressed?

Addressing, in the review, the lessons learned from the crisis is an understandable reaction to what has happened, but the approach taken to identifying the issues raises two concerns. First, the focus appears to have been only on the perceived failings and has not sought to identify why those who came out of the crisis well did so and how any future regime can build upon their successes. Secondly, and possibly more significantly, the absence of a market failure analysis means that important considerations that may
be identified when starting from a blank piece of paper may be lost when focussing purely on experience to date.

In particular we would highlight the following areas as being key to the review:

- **Objectives** – The objectives of the regulatory framework, in particular the soundness standard sought and the purpose/role of the various elements needs to be agreed and articulated

- **Scope** – The trading boundary is an important consideration, which is identified elsewhere in the discussion paper. As noted in our comments relating to chapter four, any change to the current boundary will have implications for other parts of the capital framework and therefore it is important to consider both the current banking and trading books in this review.

- **Market failures that are risks to the regulatory objectives** – We would like clarity on what the failures are perceived to be and what the framework should therefore address. The identification of market failures will help inform the options that may be appropriate for any new framework. In our view the most significant failure is likely to be negative externality; in this case the mis-pricing of risk. Therefore the goal of the review should be to agree a framework that appropriately captures and sets capital against the material risks, but which also provides incentives to positive behaviours. To this end it is important for supervisors to understand the risk management frameworks in which firms are operating.

- **Regulatory failures that are relevant to the regulatory objectives** – In part the discussion paper has gone some way to identify these but not in a way that coherently seeks to address them. This section of the discussion paper picks up on the inconsistent application of standards across jurisdictions. Therefore the goal should be to agree a framework that is acceptable to all and is sufficiently clear that it can be applied by all. The DP highlights, elsewhere, the fact that there is now a patchwork of regulation in this area which is complex and duplicative in places, and therefore may not be the most effective and efficient approach. The goal should be to identify a coherent package of measures that appropriately address the risks without double counting risks or capital charges.

- **The appropriate methodologies and exposure values to be used in determining capital requirements**. The review should consider the role that strategy and active risk management plays in determining the appropriate capital requirements.

We continue to believe that there should be an appropriate differentiation between the capital requirements that result from more sophisticated and more accurate models versus less sophisticated less accurate models. It is important for such a distinction to exist both to encourage and reflect improvements in risk measurement. Therefore we query the apparent desire, expressed in the discussion paper, to narrow the gap between modelled and standard rules capital requirements. The capital requirements should appropriately reflect the relative crudeness/inaccuracies of the modelling approach adopted. We note that the DP does not provide any insight into how well the
standard rules performed during the crisis and would appreciate further dialogue with the FSA on this point.

Chapter 6 - Valuation

Q3: Do you agree that valuation uncertainty should be dealt with via additional capital requirements? If not, what alternative approaches could be used?

Q4: In practice how can valuation uncertainty be consistently calculated?

The DP seems to confuse valuation uncertainty with valuation consistency. Institutions use differing underlying assumptions in their models and, indeed, differing models, which together with their differing risk appetites and differing portfolios will lead to a range of acceptable valuations. Provided that the assumptions and techniques are valid, a range of outcomes, per se, should not be regarded as valuation uncertainty. That said, as with any model, a valuation model represents a set of simplifications of the conditions it is trying to capture. Firms should be aware of the limitations of their models and react accordingly. Indeed to address this, and for other reasons, firms routinely include adjustments within their valuations to reflect methodological imperfections. While we can see some potential attractions of greater consistency of valuation methodologies to regulators, it is important to remember that if all firms are forced toward a single approach, this will create systemic risks, as all firms will likely react in the same way to a market shock.

Some firms may be more conservative in their valuation approaches than others. A valuation uncertainty capital charge is unlikely to be able to capture such differences and is likely to penalise those who are conservative and potentially create perverse incentives. It is, however, legitimate for supervisors to understand where firms sit on the spectrum of conservatism and to address issues that follow from different approaches though Pillar 2.

However, we would agree that, in less liquid markets, and in times of stress, valuation becomes more difficult to determine because of the relative lack of willing buyers and sellers. Supply and demand issues are difficult to predict, as evidenced by the recent crisis. Any future crisis is unlikely to replicate this one or those that have gone before. We understand that regulators want to address current liquidity in the valuation. However, determining potential future liquidity would be difficult and subject to significant uncertainties. The issue of future uncertainties such as these could be addressed by other means such as the broader stress testing framework, as in the current framework through stressed VaR, or potentially through other means. Given this range of available techniques, we do not think the FSA should consider a valuation uncertainty charge in considering the issues raised by less liquid items.

As regards issues surrounding structural one way positions, it is difficult for individual firms to take a view. Supervisors are in a better position to determine that there is an issue in this instance.
We are also of the view that a valuation uncertainty charge would be procyclical (imposing additional capital requirements as liquidity declines) and would create systemic risks. Therefore it would not achieve the objectives being sought.

We would further note that some of the issues surrounding CVA are being addressed as part of the Basel 3 package, where an amended form of the bond equivalent approach is being developed, and that the modelling aspects of CVA are going to be addressed by the Trading Book Working Group of the Basel Committee.

Given all of the above, it is important for firms and supervisors to understand the range of potential valuations, the level of conservatism of the valuation approaches used, and the impact that on capital if market liquidity dries up, to help to ensure that the firm can act appropriately when issues arise. Therefore, while we do not believe that it is appropriate to consider an explicit capital charge for valuation uncertainty, the systems and controls around valuation processes are a legitimate subject for supervisory review and discussion under Pillar 2.

Q5: Do you agree that detailed regulatory valuation rules be defined to ensure consistent standards in the application of fair value? If so, what areas would most benefit from such guidance?

No. The accounting standard setter should continue to be regarded as the primary source of the definition, and guidance on the application, of fair value. Regulators have a role to play in encouraging the accounting bodies to agree global standards; discussing with the accounting bodies the issues that arise as part of the supervision activity; and by sharing examples of good practice.

We accept that, in some cases, the accounting objectives are at odds with the regulatory objectives (for example in relation to own credit valuations) and that prudential filters may therefore be warranted. However, we do not support the introduction of regulatory valuation standards as a general principle, nor do we think that many filters are necessary. Filters should be agreed internationally, although their relevance in particular jurisdictions (if convergent accounting is not achieved) may differ.

The Basel Accord and the Capital Requirements Directive, as reflected in GENPRU, already includes guidance on prudent valuation. Consistent application, by supervisors, of the prudent valuation framework is important to ensure that a level playing field exists and should be a matter for the Standards Implementation Group in Basel and the European Banking Authority; it does not require the development of regulatory valuation rules to be applied by firms.

Q6: Do you agree that a separate regulatory valuation model is not justified? If not, why not?

We think that it would be inappropriate to develop a separate regulatory valuation model. Developing a parallel set of regulatory valuations would be costly for firms to implement and create confusion with investors if a parallel set of valuations are used for regulatory purposes than for financial statements.
Q7: Do you agree that regulators should be able to adjust valuation approaches based on principles agreed at an international level? If not, how can regulators address the problem of significant differences in valuation approaches?

While we agree that there are differences in the scope of fair value between national GAAP and IFRS, we think that the changes to the accounting framework to deliver an expected loss basis for provisioning will go some of the way to addressing the problems identified as a result of the crisis. In addition we would urge regulators to encourage the accounting standard setters to converge in their approaches, which will help to provide a common starting point for all firms. Consistency of the accounting framework should be the starting point.

We believe that the focus should be on developing a coherent regulatory framework that can operate with such differences rather than to force firms to pursue a separate set of valuations. However, any prudential filters necessary should be agreed at the international level.

Q8: How should a set of rules that form the basis of a regulatory approach to valuation be constructed?

The starting point for valuation should be the accounting framework. In limited circumstances, the differing objectives of the accounting and regulatory regimes may require adjustments to be made, but separate rules are not necessary. The regulatory capital framework, designed as it is to deliver capital against unexpected losses, should be calibrated appropriately across the spectrum of liquidity and accounting approaches to ensure that it does not create perverse incentives. The question then becomes one of consistency of application of the prudent valuation framework – this topic should be the subject of discussion in the Standards Implementation Group and the European Banking Authority. The approaches to valuation taken by firms should be the subject of discussion as part of the pillar 2 process.

Q9: Do you believe the series of adjustments presented in this chapter would address the weaknesses identified during the crisis? If not, what other measures could be introduced?

No. The approaches proposed do not appear to create the appropriate incentives to encourage the identification, quantification and management of uncertainty and are likely to punish firms who take a conservative approach and have good controls in place. As noted above we are concerned that the proposals will create further procyclicality and result in duplication of risk coverage.

A more appropriate approach would be to provide incentives for firms to invest in their risk identification and measurement tools and for supervisors to engage in robust discussion with firms on their valuation approaches, controls and processes.

Q10: Do you agree that a carefully designed valuation uncertainty charge could help to mitigate the leverage enabled by reliance on exuberant market prices?

No. Risk mis-pricing in certain sectors was one of the factors that contributed to the build up of leverage in the crisis. Inadequate due diligence practices and an over-
reliance on deficient risk measures in certain sectors caused some of the exposures taken on to be under-priced compared to their real risk and so contributed to the creation of an asset bubble. Mis-pricing was not the only contributing factor to the build up of leverage; the availability of cheap money over a sustained period of time and an over-reliance on short term secured funding were also factors.

A capital charge for uncertainty would not necessarily address the problem of leverage building up because it would not provide an incentive for firms to invest in risk identification and measurement tools and would likely penalise those firms who behave conservatively and have good controls. While we still have a number of outstanding issues with respect to the leverage ratio, we think that a tool more specifically targeted at leverage is a more appropriate way forward. The convergence of accounting standards on the international benchmark would also help here.

Q11: What other measures could be used to mitigate the pro-cyclicality of fair value?

Fair value by its nature will be procyclical as it portrays a firm's position at a particular point in time. It is important that financial statements continue to give users useful information of this nature for them to make informed decisions. In a regulatory context, excessive procyclicality of the framework should be addressed to provide for appropriate capital levels when entering a downturn, but this is essentially a macro-prudential issue which should not be addressed by altering the valuation standards issued by accounting bodies. To the extent that firms need capital to withstand market shocks there are other tools available for the purpose, such as broader stress testing, or stressed VaR.

Chapter 7 – Coverage, coherence and the capital framework

Q12: Do you agree that the structure of credit markets means that credit positions have a different risk profile to those in other markets? If not, why not?

We do not believe that the nature of risk in the credit markets is different from the nature of risk in other markets which are not labelled “credit”. The Basel Committee in its working paper no. 16 “Findings on the interaction of market and credit risk” in May 2009, supported this view, saying:

“Market risk and credit risk can be distinguished on the basis of identifying the latter with (actual or expected) default. A straightforward way to define default is the failure to meet a contractually pre-determined obligation. As the same economic factors tend to affect both types of risk, drawing a clear distinction between them in practical risk measurement and management is, however, very difficult. Even if distinct factors could be separately associated with the two types of risk, they often interact significantly in determining asset values, and therefore risk measurement and management needs to explicitly account for their joint influence.”
We believe that the main drivers of the risk in these instruments, along with the broader framework, need to be determined and addressed. These could include default risk, the hold time to maturity, and liquidity of the risk.

**Q13: Do you agree that a consistent approach to credit default risk should be applied across all positions? If not, why not?**

This question goes to the heart of the question over whether there should be a trading book boundary, on which we offer some thoughts below.

Any boundary inevitably results in the need to consider which side of the line particular exposures fall. That type of assessment is not unique to the trading book, as there are many boundaries within the regulatory capital framework. As a general point boundaries are not necessarily a problem provided that the treatment either side of them is appropriate, and given the role of Pillar 2 in addressing risks not adequately tackled in Pillar 1.

We think that there are a number of ways to take forward the debate on the trading book boundary:

1. No change – definition based on trading intent
2. Boundary based on the definition of trading activities
3. Boundary based on definition of non-trading activities
4. Boundary based on accounting
5. Trading, Banking and Intermediate category each with its own capital rules
6. Continuum approach
7. Single model

1. No change – definition based on trading intent

There are perceived shortcomings with the existing boundary, largely because of the historic differences in treatment which have accorded significantly lower capital requirements to trading activities that in turn created incentives to book instruments in the trading book. In addition, the concept of ‘intent’ is difficult for supervisors to police and allowed exposures to be included where the capital requirements were arguably insufficient for the risks. Further, the concept of ‘intent’ was overaken by events during the crisis, where the inability to hedge or exit exposures within a short time horizon was demonstrated, i.e. intent may not always be matched by ability.

2. Boundary based on a definition of trading activities

Under this approach inclusion in trading book would still require exposures to meet certain tests, otherwise they would be deemed non-trading book. If such an approach is taken forward it will be necessary to review a number of factors, some of which are already contained in the current definition:

- Business model – including trading strategies, risk monitoring and management
- Liquidity of risk/ability to hedge
• Whether the exposure is considered a hedge of a banking or trading activity
• Intent
• Proven ability to execute that intent.

3 Boundary based on a definition of banking activity

Such an approach would flip the previous assumption that exposures are non-trading unless they can be proven to be otherwise, i.e. there would be a presumption of trading activity. In light of the crisis, where some firms lost significant amounts on their trading activities, this approach may be perceived as a counter-intuitive, but if the capital requirements are appropriate either side of the boundary and risk management is more active in the trading book, then the incentives for firms to undertake appropriate actions are retained. Intention, strategy and ability to hold to maturity would therefore be important considerations in this setting.

4 Boundary based on accounting

A boundary based on accounting may be attractive, as it would recognise the price risk associated with exposures that are fair valued. However, it would not take account of the fact that fair value is not necessarily market value. Some items fair valued are valued less frequently than daily and risk managed in a different way to those that are actively traded. In addition an accounting based approach may create a divergence between some items and their hedges because of the difficulty in achieving hedge accounting (e.g. interest rate hedges on loans and deposits). Furthermore, accounting operates at the instrument level, whereas hedging may be achieved in practice at the risk factor level. Finally, there is potential for unforeseen consequences with changes to accounting affecting risk management practices – for example portfolios held for the liquidity buffer are unlikely to receive an accrual accounting treatment under some proposals but given the purpose of holding them, they should be managed as banking book items.

5 Banking book, trading book and intermediate category

Another alternative would be to have a third category between banking and trading for exposures where intent and ability to trade may not be matched. There are advantages in that specific issues around these items could be addressed but there would also be a need to define and police two boundaries.

6 Continuum

This approach would obviate the need for a boundary determination and would assess capital requirements along a spectrum of liquidity horizons from highly liquid, frequently traded, actively managed and marked to market to not liquid, infrequently, if ever traded, managed to maturity and historic cost accounted. Different approaches could be used dependent on the risk drivers and the way that exposures are managed.

7 Integrated capital model

Another option would be an integrated capital model, i.e. a single approach to cover both current banking and trading books. This option would also eliminate any
boundary problems. For example, the model might be estimate expected shortfall, with liquidity addressed though a cost of exit add-on.

In the absence of clarity over the objectives and soundness standards being sought in the trading activities review, the industry has not yet reached a view on the most appropriate way forward in respect of the boundary, but hopes that the options presented above will provide helpful input into your thinking.

Once a view has been established on the appropriateness of having a boundary and the methodology for establishing it, the next consideration should be to determine appropriate capital standards. To that end the framework should aim to ensure that the material risks are addressed and that material drivers are considered. The relevance of a material risk driver may be different depending on why the position is held, how long it is to be held for, and how it is managed. A consistent outcome for positions either side of the boundary if they are exposed to the same level of default risk is desirable, but it does not mean that it has to be achieved in exactly the same way. And any approaches taken should still provide incentives for hedging.

Q14: Do you agree that a net position in a fair-valued credit product should have a higher capital requirement than a net position in an amortised cost position? What type of netting should be allowed for each position and should it be consistent across all positions?

No. We would suggest that the review should also consider examining the economics of the instrument and its underlying risk factors and the market in them, rather than just its accounting treatment. Positions in the trading book are actively risk-managed on a daily basis. Positions in the banking book are managed in a different way to reflect the firm’s longer term strategy.

Permissible offsets in credit positions are currently very restricted – in the standardised approach they are limited to positions in instruments of the same issuer and even this treatment does not fully recognise good risk management practices. Hedging, however, should be encouraged, and therefore we think that there should be greater scope for offsetting in the framework, where it reflects a genuine reduction in risk. A default risk charge should allow for offsetting between bonds, loans, counterparty exposures on derivatives and credit derivatives. We recognise that basis risk does need to be taken account of in making that determination. We believe that modelling should be allowed to recognise offsetting on the basis of the level of correlation, (as currently allowed by the IRC), and not restricted e.g. to debt instruments of the same issuer. Such offsetting would require the exposures to be valued on the same basis (i.e. both sides either fair valued or accrual accounted).

Q15: Do you agree that the three options presented are the main options available to capture credit risk? If not, what other approaches could be applied?

As noted in our introduction we continue to believe that modelling has a fundamental role to play within the framework. Larger institutions are likely to favour a full modelling approach, but this may not be feasible for smaller institutions and therefore, there should be a range of approaches available. Capital requirements associated with these different approaches should reflect the degree of accuracy they attain. Various
options should be considered even for modelled approaches and we would not want to
stifle debate at this stage. As noted in the boundary discussion above, one option that
could be considered would be to take account of the different liquidity risk horizons.
However, there are other options that should also be considered. We prefer a balance
tipped in favour of principles over detailed rules, which can stifle innovations in risk
measurement and management, but agree that it may be appropriate for regulators to
set some aspects in rules to deliver consistent outcomes. We would like to engage in
dialogue with you on the relative balance between rules and principles once the
appropriate options have been determined. We would note that caps and floors are not
the only way that appropriate levels of conservatism can be introduced into the
framework and in general regard measures linked to standard rules as inappropriate
for this purpose.

Restricted modelling potentially raises issues in relation to hedging, if it is possible for
positions and their hedges to fall either side of the modelling boundary. It may also
break the link between the regulatory approach and the firms’ use of the model
internally, if the use test continues to be a part of the framework. There may also be
other methods, other than exclusion from the model, to address perceived shortcomings
that concern regulators. Since the DP is not entirely clear on what basis the restriction
would be imposed it is not possible to provide appropriate suggestions. As a single
solution, this would probably not be appropriate for some smaller firms. However,
further benefit in any standard rules for hedging is welcomed and should be considered
regardless of the modelled approach decided upon.

Purely focussing on a standard rules approach is likely to deliver a sub-optimal result.
While we agree that standard rules have a place within the framework, they are always
going to result in a cruder, less accurate result. Standard rules do not provide an
incentive for development of risk measurement and management techniques. We
would agree that a range of approaches should be developed. However, approaches
based on products are unlikely to cater for hedging conducted at the risk factor level (a
common practice in advanced firms). Therefore sophistication of the institution
concerned should be the primary determinant of use.

Whatever approaches are taken forward, hedging should be encouraged.

Q16: How could rules around netting in the restricted modelling approach for
credit assets be applied in practice?

We do not favour the suggested restricted modelling approach as an appropriate way
forward as a single approach. Offsetting should be part of a flexible modelling approach
and how well a bank recognises offsets in its model will depend on its capability and
readiness to model correlations. Hedging more broadly should be encouraged, although
as noted above we agree that basis risk should be taken into account.

Q17: How could complexity be defined in a consistent way to tailor the approach
to credit risk?

We do not think it is beneficial to attempt to define complexity, as this is a subjective
concept that will change over time. Such an approach was attempted in CRD 3 in
relation to re-securitisations and failed because of the difficulties. Complexity depends on a firm’s risk management capability and therefore is not susceptible to a single definition that could be applied consistently across all firms, i.e. what is complex to one firm may not be so to another. We would agree that to use models for regulatory purposes, the model should appropriately capture the risk. In relation to new and more complex products, firms should not automatically be prohibited from entering the market, but think that appropriate conservatism can be introduced into the framework to address any shortcomings in modelling.

Q18: Do you agree that whether a position is fair valued should determine whether it attracts a market risk capital charge? If not, what alternative approaches could be used to improve the boundary issue?

Please see the answer to question 13.

Q19: Do you agree that there should be a differential approach to market risk capital standards based on an assessment of liquidity during adverse market conditions? If not, why not?

As noted in the key messages, it is necessary to answer some prior questions before being able to address the issue raised in this part of the DP; notably the soundness standard sought for the framework and the purpose of the various elements of the requirements in delivering that outcome. Therefore it is not possible to fully answer this question at this time. However we would note that the problem with trying to model adverse conditions is in attempting to calibrate adversity – it is not possible to predict how adverse a market will become and whether liquidity will be affected in the same way across all products. It is not therefore appropriate simply to add all adverse market liquidity assumptions together. These considerations make it difficult to set a level of capital to cover the risk ex-ante and likely to go beyond the appropriate safety standard.

Q20: Do you agree that the calibrations of the prudent valuation requirements and the market risk capital requirements should be linked in a consistent manner? If not, why not?

No. As noted elsewhere, we do not support regulatory valuation requirements within pillar 1, nor do we support capital for valuation uncertainty. As a general matter, fair value accounting standards require firms to mark to an exit price net of provisions. Regulatory capital should support unexpected loss in that exit price given a firm’s strategy and to a consistent soundness standard.

Q21: How do you believe asset market liquidity should be measured?

The liquidity of instruments is not necessarily the same as the liquidity of risk factors. Valuations are determined in relation to instruments not risk factors. Therefore measuring an appropriate concept of liquidity is not a simple matter. The determination of the liquidity of an instrument could take account of bid/ask spreads, market depth, and asset funding (i.e. if a firm is funding to term it will not be a forced seller so should not bear liquidity charges on top of funding charges). Beyond that
however any determination might then consider the liquidity of the relevant *risk factors*. It may be possible to set consensus liquidity horizons to deliver some standardisation to the model, but this needs further consideration.

**Q22: How should regulators look to implement a liquidity market charge in a way that would not be pro-cyclical or stifle innovation?**

Liquidity declines in periods of stress but firms cannot manage cycles and attempting to calculate the liquidity horizons at every point in time would be pro-cyclical and arbitrary. In line with our key messages, we also think it is inappropriate to calibrate the requirements to severely stressed conditions. Furthermore, creating a framework that is entirely ‘through the cycle’ would potentially stifle innovation.

As noted in the answers to questions 3 and 4 we do not believe that a valuation uncertainty charge is an appropriate way forward. To the extent that liquidity is included within the framework, a better approach would be to incorporate it into the holding period in some other way. For example, capital requirements on the basis of consensus liquidity horizons would not be pro-cyclical as the horizons would remain constant. Stress testing, or stressed VaR, as ex-ante approaches, would not be procyclical either. It is also important to note that, firms will be subject to liquidity standards and we believe this should be taken into account when developing the framework. We therefore think it is premature to decide on an appropriate solution at this stage.

**Q23: Do you believe that IRRBB should form part of the Pillar 1 framework? If not, why not?**

Firms do seek to manage/hedge IRRBB and any framework developed should aim to take account of this activity. We agree that the risk should form part of the regulatory framework but are neutral, at this stage, as to where it should be located, given the absence of clarity on the purpose of the various pillars of the regime, and the boundary issues. It is important to bear in mind that any framework developed needs to be practical to implement, appropriate on an international basis and should be mindful of unintended consequences.

**Q24: Do you agree that the three options represent the main alternatives in producing a long-term approach for CVA volatility? If not, what other alternatives could be considered?**

We agree that those are the main approaches for capitalising variation of a market-based CVA. However some firms calculate a CVA based on a buy and hold strategy, and for those historic PD/LGD based CVAs, a calculation based on the variation of internal ratings is more appropriate. We will be happy to contribute to regulatory thinking as it develops.

**Q25: Do you agree that contingent market risk should be captured in the regulatory framework? If not, why not? If yes, how can it be captured – would stress tests be sufficient and if so how could they be applied consistently?**

And
Q26: Do you agree that capture of gap risk within the regulatory framework should be improved? Is stress testing the best approach to quantify the risk, if not how could this be done?

And

Q27: It is clear that firms face significant hedging risk/ costs that can be material loss drivers. How should this be captured in the regulatory framework? Should this be done through internal models being required to reflect the risks of a dynamic portfolio rather than using a constant risk assumption?

The question pre-supposes these risks are not already considered in risk modelling by the banks, and adding cumulative separate capital requirements against every type of risk that can be identified loses sight of the relationship between risks. We believe that some level of assumption of risk has to be accepted for the market to operate. In our view contingent risk is simply a tail event and analysis of it (perhaps via stress testing) would be part of normal modelling for tail risk. We would particularly challenge the statement made in paragraph 7.68 that banks “continue to add risk to their books” in a market contingency such as those mentioned. During the financial crisis, the liquidity problems showed that banks were downsizing risks across the board.

Chapter 8 – Risk management and modelling

Q28: Do you agree there should be greater oversight of risk management functions in firms, including front office activities? If so, are the standards set out in Box 8.2 and Box 8.3 the type of requirements regulators should expect to see? What tools could regulators use to achieve these outcomes?

Risk management is important both in the context of the controls around models and also more generally around trading activities and we would agree that all firms should have appropriate risk management standards (proportionate and appropriate to the business that they undertake). The FSA already has the power to assess the adequacy of a firm’s risk management standards. SYSC 7.1.14 already states: ‘A BIPRU firm must implement policies and processes for the measurement and management of all material sources and effects of market risks. SYSC also includes requirements in relation to risk assessment functions and management information.

We agree that Boxes 8.2 and 8.3 cover relevant issues. However, we do not think that this level of detail should be included in rules, as firms are all different and have different approaches to risk management. The most important tool the FSA will require to determine the adequacy of risk management standards will be appropriately skilled and experienced staff to interact with firms’ management. Assessing the appropriateness of risk management standards can never be a ‘tick-box’ exercise, it requires skill, knowledge and judgment. Colleges and peer reviews are also likely to be useful tools. We also think regulators have a role to play in sharing good practice with the industry as well as with each other.

In undertaking the fundamental review of trading activities it is important to consider the interaction between risk management and capital. Capital is not the only answer,
and the regulatory framework should continue to provide incentives for good risk management and not discourage the development and adoption of better risk measurement and management practices.

**Q29: Do you think that internal models should remain part of the regulatory capital framework? If not, what other ways could a risk-sensitive capital requirement be assessed?**

Yes. We believe strongly that models should be part of the regulatory capital framework.

Sound financial models, supported by appropriate controls, are the best way to measure and allocate risk. Risk models are designed to emulate the complex dynamics observed in markets using quantitative techniques, which allow for the measurement of potential loss in the underlying portfolio. Models (which capture all material sources of risk, where supported by appropriate controls, and where the limitations are fully understood by users) offer the most accurate means of measuring risk and therefore should have a central role to play in the regulatory framework. We acknowledge that models, by their nature, are never perfect - they are the result of carefully thought out trade-offs involving generalisation, simplification, approximation and assumptions. However, provided they are supported appropriately and limitations are understood, as suggested above, they still offer the most appropriate way forward. In undertaking the review, we see no reason why any particular product or sector of the market should necessarily be excluded from being modelled, provided appropriate standards can be met.

We are concerned that the question indicates that the regulatory community is minded to move away from models in the prudential regulation framework. While we acknowledge that some firms had problems with some products and some models during the crisis, there was not a uniform failure of modelling across all firms. For more liquid products, such as FX, VaR performed well during the crisis. Therefore it is important not to abandon modelling.

In relation to the standard rules, we continue to see a place for both sophisticated risk modelling and more simplistic approaches in any future regulatory capital regime. It is important that any future framework takes account of the full variety of firms in the market and contains appropriate and proportionate approaches for all.

We continue to believe that there should be an appropriate differentiation between the capital requirements that result from more sophisticated and more accurate models versus less sophisticated less accurate models. It is important for such a distinction to exist to encourage improvements in risk measurement. Therefore we query the apparent desire, expressed in the discussion paper, to narrow the gap between modelled and standard rules capital requirements to a minimal amount. The capital requirements should appropriately reflect the relative crudeness/inaccuracies of the modelling approach adopted. We note that the DP does not provide any insight into how well the standard rules performed during the crisis and would appreciate further dialogue with the FSA on this point.
Q30: Do you agree that improved modelling approaches should be developed to measure risk? If so, what alternative modelling approaches could be investigated?

In our view, articulating the soundness standard being sought and the purpose of Pillar 1 and 2 going forward is a prerequisite to determining the most appropriate models to use for the determination of regulatory capital. The degree to which stressed results determine regulatory capital will be determined by this articulation and also by other elements of the framework that have recently been developed such as the regulatory buffers.

There are also important principles that should be borne in mind in determining the most appropriate modelling approaches:

- Regulatory capital should be proportional to risk.
- All material risks should be captured.
- Approaches considered should encourage the development of better risk measurement and management standards.
- Approaches adopted should not result in the capital requirements double counting the risk.
- Regulatory capital framework should capture risk factors rather than focusing purely on products.
- Model validation is important.

At this stage we would not wish to rule out any particular approach, all options should be considered including the continued use of VaR. Issues that could be considered, depending on the view of the soundness standard and the purpose of Pillar 1, when identifying appropriate models include:

- Correlation or co-movement assumptions;
- Risk type
- Time horizon
- Liquidity – i.e. ability to hedge the risk, not necessarily the product.
- Appropriate risk horizon
- Ability to validate

Q31: Do you agree that back-stops and stress testing should have a more significant role in setting capital requirements? If not, why not?

Again, the extent to which backstops or stress testing may be necessary will depend on the soundness standard set and the articulation of the purpose of the various parts of the regulatory framework. For example, the extent to which Pillar 1 includes downturn/stressed parameters, the requirements for further stress testing should diminish. Similarly the extent to which the various buffers are intended to capture risks will have an impact on what is required of Pillar 1 or 2. There is also a trade off for regulators to determine between the accuracy of an approach under Pillar 1, with its
consequent effects on procyclicality, and the extent to which backstop or stress testing measures might be needed.

That said firms have seen the value of stress testing and improved their approaches as a result of the crisis. Stress testing is, however, difficult to incorporate into a regulatory capital framework. An appropriate stress test set for one firm may be wholly inappropriate for another with a different business model. In this context, a principles based approach requires considerable skill and judgement to determine the comparability of the levels of stress applied across firms.

Simple backstop measures, such as a limit on activities (suggested in the issues paper by the Independent Commission on Banking); or on business lines; or portfolios (suggested in the Karas Own Initiative Report) are likely to result in perverse incentives for risk management. This would be undesirable in our view. Use of standard rule floors can have similar impacts by stifling improvements in risk measurement and management and create operational difficulties. In general, therefore, we do not support the inclusion of simplified backstop measures.

Q32: Do you agree that internal model approval should be supplemented at a Basel level to improve consistency? If not, why not, are there alternative options?

International consistency of regulatory requirements and their implementation is obviously important to deliver a ‘level playing field’. However, we do not believe that involving the Basel Committee in the approval of individual model applications as the most appropriate/efficient method of achieving this objective, as it would inevitably slow down what is already a lengthy process.

Supervisory colleges for international groups have been established, where they were not already in place, and should be the basis for ensuring that an appropriate approach is taken to individual firms by encouraging the sharing of information and for the foundation of supervisory discussion. There are certainly lessons to be learned from the supervisory college discussions and we can see a role for the Standards Implementation Group and EBA in pulling together those lessons and to ensure that a consistent approach is taken across jurisdictions.

Q33: Do you believe that the measures presented in this chapter would address the issues related to risk management and modelling identified during the crisis? If not, what other measures could be introduced?

We would reiterate our comments that the soundness standard needs to be identified and that the purpose of the various elements of the regulatory framework (Pillars 1 and 2, buffers etc) should be clearly articulated. In addition the principles that we have outlined in question 30 and in our key messages also need to be addressed. It is particularly important that the review not merely seek to address issues from the last crisis but should seek to build a regime that is flexible and outcome focussed so as to be able to cope with future developments and any future crises. However, on that note, we would highlight that the framework should not be aiming for a zero failure regime for CRD firms. Members are also conscious of the need to determine an appropriate
soundness standard for central counterparties, which may not be the same as that for banks and investment firms

Chapter 9 – A new framework in practice

Q34: Do you agree with the key policy questions that will determine the appropriate course of action? If not, what other key questions need to be addressed?

Q35: Do you agree that these paradigms represent the spectrum of frameworks that could be developed to address the key issues identified in this DP? If not, what other ways could a framework be developed?

Q36: Which paradigm do you believe represents the most successful solution presented in the DP and why?

Q37: Do you agree that these proposals will bring economic benefits by improving financial stability and market confidence? Do you agree with our high-level impact analysis for each paradigm? If not, what other costs and benefits do you think each paradigm may have on the market and the economy?

In light of our earlier comments regarding the need to undertake a more fundamental review from first principles, we think that it is premature to comment on these questions.

If you have any comments or questions regarding this response please contact, Diane Hilleard (diane.hilleard@afme.eu), David Murphy (dmurphy@isda.org), or Irving Henry (irving.henry@bba.org.uk).

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