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Association for Financial Markets in Europe

AFME Position Paper

CRD 5: Market Risk Framework

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Implementing the BCBS FRTB in an appropriate manner in Europe

AFME considers that the Fundamental Review of the Trading Book (FRTB), or new capital framework for market risk, as agreed by the BCBS should be adopted into the EU legislative framework in as consistent manner as possible with the international standard. However, there remain a number of design and calibration issues with the BCBS framework which need to be addressed urgently at the BCBS level. There remains significant uncertainty regarding the overall impacts of the final FRTB rules as impact assessments have been limited in scope so far and analysed only at an aggregate level. What is already known however is that the rules will have disproportionate effects on certain products and markets, particularly those that finance the real economy and it should be ensured that they do not negatively impact on the way banks intermediate in capital markets.

While we are supportive of a market risk capital framework that introduces proportionality for smaller financial institutions with limited market risk exposure[1], it is crucial that the framework for larger banks be appropriate too. Capital and financial flows tend to be global in nature, with investors and issuers from across the globe using the services of globally active banks to find the most attractive investment opportunities and efficient financing solutions respectively. Such financing and market-making activities are therefore typically conducted by globally active wholesale banks that can reach investor bases across the world. These tend to be larger institutions and any changes in market risk capital requirements for such banks will have a proportionately bigger impact on the functioning and liquidity of markets than similar changes would for smaller banks. Moreover, if the FRTB results in disproportionately high capital charges for certain asset classes and regions, banks may withdraw capacity from these markets. This would impact both liquidity and pricing, with negative consequences for end-users. Additionally, this would also go against efforts, such as the EU's CMU project to increasingly develop capital market based financing.

As it stands, the BCBS FRTB framework has a number of design and calibration flaws that still need to be addressed. Given the importance of consistent international rules in this respect, these issues should be corrected at a global level. Consequently, we believe it is necessary for the EU to support these adjustments within the BCBS and for the EU implementation of the FRTB to be flexible enough to accommodate ensuing international developments. Moreover, the FRTB rules' impact on region specific products (such as covered bonds in Europe or Agency securities in the US) should be carefully addressed to avoid undue damage to local markets without any financial stability benefits. More details on the areas that still require adjustment are provided below.

Finally, we wish to point out the challenges in implementing the new market risk framework into the CRD at this point in time given the ongoing discussions at international level on the design and calibration of the RWA framework and capital floors. In this context, it is important to highlight the commitment made by international and European bodies (the GHOS and ECOFIN respectively) that overall capital levels will not increase significantly. Any increases that arise from the introduction of the FRTB must be factored into this assessment and, as noted above, the consequences for market making of an increase in market risk capital, even if it effects only a relatively small number of banks, must be carefully considered given the broader economic implications for the development of market based finance.

[1] Please refer to our comments to the EC's consultation on the proportionality of the future market risk capital requirements

Adjusted calibration and an improved assessment mechanism of model performance are essential to avoid negative impacts on the development of capital markets

The new market risk rules contain standardised (SA) and internal model approaches (IMA). As they stand, there is currently too large a difference between the level of capital requirements resulting from these two approaches, with those of the SA far exceeding those under modelled approaches, notably due to the lack of recognition of diversification benefits.

This is problematic because banks are only allowed to use internal models for desks that pass a specific test, the so-called P&L attribution test. While we agree with the principle of using a test to assess model performance, the P&L Attribution eligibility test has never been used in practice and has not gone through sufficient testing/QIS. Its proposed design will cause otherwise well-functioning models to be rejected unnecessarily. For instance, desks with low P&L variance are more likely to fail the test. Furthermore, P&L variance caused by month-end valuation adjustments or market closes across different time-zones will unnecessarily fail models that have good predictive capability. As a result, the capital impacts of the FRTB may far exceed initial expectations[2].

Several actions are required to address this issue. Firstly, the SA needs to be recalibrated to reduce the gap to internals models for certain risk classes. The Basel Committee's objective was to have close to 1:2 relationship between the internally modelled and standard approach based capital. However, for certain asset classes the gap between the two is much higher, almost twice what was intended. Secondly, the P&L attribution test needs to be refined. We have shared suggestions with the EBA and the BCBS working group on how this could be achieved and recommend that the Commission be given a mandate for a delegated act in the CRD/R to finalise the mechanism and data basis for this test.

More specifically, the treatment of a number of product areas within the FRTB that are crucial to the functioning of capital markets or the provision of market based finance also require further reflection before the open areas of the FRTB are finalised and introduced into the EU prudential framework.

Corporate bonds and small cap equity market

The FRTB framework comprises strict conditions under which banks are allowed to model various risk factors in a modelled risk measure. This includes for instance a requirement for continuously available "real" prices which is defined as 24 observations per year with a maximum interval of 30 days between 2 consecutive observations. If this criterion is not met, the risk factor if classified as "non-modellable" (NMRF). Based on industry analysis, only circa 50% of bond issuers would fulfil this requirement. Many markets tend to exhibit seasonal behaviour, with limited trading during the summer months or at the end of the year. Furthermore, by definition, new issuances will not exhibit the necessary time series of real prices for the first 12 months after issuance.

Being classified as a NMRF significantly increases capital charges which, in turn, will have a negative impact on market making activities in corporate bonds and decrease the overall liquidity available in the market. This runs counter to the goal of developing European capital markets and reducing reliance on bank funding in the context of the Capital Markets Union. It will also make it particularly harder for smaller European corporates to obtain market based funding. The industry is in the process of establishing best practice data pooling solutions to satisfy the modelling criteria. It is essential that such solutions be allowed in the FRTB as

[2] Appropriate calibration of SAs across risk classes are also essential in the context of ongoing international discussions on the possible introduction of an output capital floor based on these SAs.

otherwise liquidity will be bifurcated between high volume liquid issuances and less frequently-traded products that may become more expensive to issue and trade.

Covered bonds and US agency securities

The covered bond market is a cornerstone of many regional European fixed income markets. The product is characterised by its double recourse to both the cover pool and issuer, ring fenced assets in case of insolvency and a strong legal framework and supervision. In terms of market trends, covered bonds will represent more than 200 Billion euros of issuance this year, while market liquidity for this asset class has been good.

In terms of credit spread risk, covered bonds are more highly correlated to government bonds than bonds issued by financial institutions. Therefore, their risk weighting should not mirror the credit risk of the issuing institution but should rather reflect the quality of the assets and the overcollateralisation of the covered pool which, based on historic performance, suggests a spread shock much lower than the 400 basis points proposed under the FRTB. Similar market behavior is also observed for US Agency (Fannie Mae and Freddie Mac) secured debt, currently classified as unsecured financials in the market risk SA. The 500bp spread shock applied to these securities is also punitive and needs recalibration in order to avoid damaging the market.

Securitisation

Under the current calibration of FRTB rules, it is likely that securitisation market-making will become insufficiently profitable. This outcome would be in clear contradiction with EU objectives to revive securitisation markets. In order to avoid this, the default risk component would need to be revisited - which will require a change to the securitisation banking book rules currently under consideration in the EU – even for securitisations that do not currently qualify as simple, transparent and secure transactions.

Foreign Exchange

The FX market is undergoing a fundamental change: global volumes are down by 23% year on year[3] while EMEA continues to account for circa 50% of volumes and real money activity (27%) has grown significantly over the past decade. Regulations are already having an impact on the cost of longer duration hedging products and there has been a significant reduction in swap roll-overs and options subject to counterparty credit risk charges. We are concerned that the FRTB[4] will result in further increases in end-user costs as banks withdraw capacity or increase pricing. Unless the rules are recalibrated, this will reduce corporate's incentives to hedge economic exposures.

Two areas of change are required. Firstly, to avoid the cliff effect discussed above, FX calibration should be revisited under both the Standardised and Internal Models Approach. Secondly, the triangle rule must be allowed. If two currency pairs have a liquid market, this implies a liquid market for the third, "overlapping" pair. For example, USD/EUR and USD/DKK are both liquid markets; it is therefore possible to trade DKK/EUR via the two liquid USD markets implying that DKK/EUR is also liquid. This is known as the "triangle rule". Unless the triangle rule is allowed, most EUR cross pairs will be subject to a flat 30% risk weight and a 20 day liquidity horizon. Furthermore, under the standardised approach the FX risk factor is defined in relation to the banks reporting currency. European banks whose reporting currency is not the USD will be penalised under the current FRTB SA as their own and client-related FX hedging transactions will attract more capital than banks with USD as their reporting currency.

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[3] Euromoney 2016 FX survey

[4] Particularly when considered in conjunction with the revised CVA charges contemplated by the BCBS

Sovereign exposures

Sovereign exposures are held by banks for several different purposes primarily linked to the management of their liquidity and their business with clients. Moreover, where a bank is a primary dealer or a market maker in sovereign debt, inventories are held in accordance with anticipated near-term client demand. The FRTB overstates capital requirements for these exposures by introducing i) a non-risk sensitive 3bps PD floor in the default risk charge, ii) requiring IRB LGDs which are or may become subject to floors and iii) increasing the shocks for interest rates under the standardised approach. These areas should be recalibrated to avoid impacts on the liquidity of trading of sovereign debt and an associated increase in funding costs.

C**ommodities**

Unless the FTRB clearly distinguishes between the notions of "commodity type" and "grade" for the purpose of aggregating commodity exposures in a risk bucket, the rules will result in higher costs for commodity producers seeking financing and hedging solutions from banks. Additionally, capital under low correlation scenarios should be made more commensurate to the risk between grades or different traded products of the same underlying commodity.

Emerging markets

A number of parameters in the FRTB framework are not well calibrated to emerging markets, and particularly to non-investment grade countries. Without adaptations to the P&L attribution test and non modellable risk factor framework, banks will be forced to operate their emerging market businesses on the SA, resulting in these activities experiencing significant capital increases compared to today. To avoid adverse effects in this area, recalibration of the SA for interest rates and FX is required, as is an increase in the granularity of ratings for credit spread risk and the ability to use internal ratings for the Standardised Default Risk Charge.

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