

Position Paper CRD V/CRR II: Fundamental Review of the Trading Book March 2017

Executive Summary

The Fundamental Review of the Trading Book (**FRTB**) is a package of bank trading book capital rules developed by the Basel Committee on Banking Supervision (BCBS), which is intended to overhaul and replace the current crop of measures with a more coherent and consistent framework. The package serves as the basis for the market risk capital revisions included in the revised Capital Requirements Regulation (**CRR II**), published by the European Commission (**EC**) in November 2016.

ISDA and AFME (**the industry**) are supportive of the original objectives of the FRTB¹, and the consistent implementation of the framework globally. However, we believe further calibration changes are required in certain areas and other methodological issues – such as the P&L attribution test and the non-modellable risk factor (NMRF) framework – need to be appropriately addressed.

If these are not tackled, then the FRTB could result in a minimum 1.4-1.5 times overall capital increase², according to industry studies. That could potentially rise to as much as 2.4 times if firms adopt the standard approach more broadly³.

The latest BCBS quantitative impact study (QIS) – based on June 2016 data from a broader set of banks from 22 countries – concluded that the weighted average overall capital increase is higher than what had initially been observed, at 67.2% for ‘Group 1’ banks, 75.9% for global systemically important banks (GSIBs) and 87.4% for ‘Group 2’ banks⁴. Such an increase in capital requirements could have a detrimental effect on certain capital markets activities⁵.

The FRTB governs the amount of capital that banks will need to hold against their wholesale

¹ The FRTB is intended to address structural shortcomings in Basel 2.5, including:

- Governance on internal risk transfers between the banking and trading book
- Development of a risk-sensitive standardised approach
- Factoring in market liquidity (i.e. introduction of liquidity horizons) and limiting diversification benefit across asset classes

² It should be noted that the FRTB’s objective has never been to further increase capital requirements but rather to improve the overall design of the framework. The previous revision of the market risk rules, Basel 2.5, had already addressed the capital issue by increasing the capital requirements significantly

³ ISDA/GFMA/IIF industry FRTB QIS analysis

⁴ <http://www.bis.org/bcbs/publ/d397.pdf>

⁵ This is acknowledged by the EC, which in its impact assessment that accompanied the CRR legislative proposals, stated that *although the design of the prudential framework for market risks has been improved with the FRTB standards, it could have a potential detrimental impact on the functioning of the EU financial markets via an excessive level of capital required for certain product types that could lead to increased prices, reduced trading volumes and restricted access to capital market for certain actors of the economy*

market intermediation businesses, which provide end users such as corporates, sovereigns and institutional investors with access to capital-markets-based funding, and capital, investment and hedging solutions. It is therefore crucial that the calibration of the framework does not have a disproportionate impact on the cost of intermediation and availability of products that are integral to the functioning of EU capital markets and the real economy.

If banks are forced to reduce intermediation activities due to disproportionate capital requirements, then the reduction in market liquidity would result in higher funding and hedging costs for end users. It would also lead to increased market volatility and systemic risk as a direct result of having fewer market-makers and a reduced capacity to warehouse risk.

The CRR proposals include a number of positive developments – for example, there is a helpful phase-in period to allow banks to adjust their market risk models and businesses to the new rules without a significant disruption to servicing their clients.. However, several fundamental shortcomings of the framework have not been addressed.

Summary of Recommendations

The industry believes several crucial changes are needed to tackle these shortcomings.

Consistency in Timing:

- The EU implementation of the FRTB framework needs to take into account both the timing and implementation of the FRTB in other jurisdictions. This is critical to ensure a globally consistent implementation that will not result in an unlevel playing field. As yet, no other major jurisdiction (including the US) has published draft legislative proposals. We therefore urge European policy-makers to:
 - Continue to monitor and consider the progress of the transposition of the FRTB in other major jurisdictions, and amend the timeline in Europe if necessary; and
 - Review and incorporate any calibration and other changes stemming from the BCBS process into the EU framework.
- Provide more time: The implementation period should be lengthened to three years after the rules are completed instead of two. This would allow at least two years between the required date for the European Banking Authority (EBA) to finalise key regulatory technical standards (RTSs) and the FRTB go-live date. The current time frame is insufficient for firms to develop internal models and for supervisors to validate them. If there is significant uncertainty about the final validation methodology, the model approval process and the resulting capital levels, then banks may reduce their appetite for market risk in the run-up to implementation – with negative ramifications to functioning of the EU capital markets.

Ongoing Assessment:

- The capital impact should be fully understood by conducting further QISs that are sufficiently granular in order to assess product-level effects. The framework should be subject to adequate calibration to ensure FRTB implementation does not lead to punitive increases in risk-weighted assets (RWAs), and to ensure that the standardised approach is a credible fall-back to the internal model approach (IMA).

Appropriate Calibration:

- Standardised approach: We are particularly concerned about the calibration of the standard approach, with industry QISs indicating that the resulting capital will be far in excess of intended levels. The calibration of foreign exchange, equities and credit risk (covered bonds, US agencies, sovereigns) is excessive. We continue to advocate that covered bonds and US agencies should be subject to 75bp credit-spread shocks instead of the punitive calibration in the proposals. We provide our more detailed calibration suggestions in section four, which includes our more detailed recommendations and reconsideration of the correlation scenarios in the standard rules. Further we note issues pertinent to the default risk charge under the standard rules in relation to the capitalisation of the hedges for equity products.
- P&L attribution test: Appropriate and fit-for-purpose internal model eligibility criteria and validation requirements (i.e. the P&L attribution test) should only be incorporated into EU rules once agreed at Basel level. At the very least, the P&L attribution test should be introduced as a supervisory reporting requirement, rather than a binding regulatory constraint until the methodology is completed and there is more clarity on the model approval process. If the test is not appropriate, and models that perform well, fail the test, then firms would be required to adopt standard approaches. This would result in a significant regulatory capital cliff-effect.
- Non-modellable risk factors (NMRFs): The NMRF rules have a significant impact on capital – making up approximately 30% of the total IMA capital charge, according to industry studies⁶. The data conditions for modellability are unrealistic (24 observations per year, no more than 30 days between two observations), particularly for smaller EU markets and issuances. According to industry analysis, only 50% of US bond issuance meets this requirement. The less liquid EU bond markets are even less likely to meet the criteria. We recommend that the Level 1 text is further refined to ensure that data-pooling solutions are allowed to limit the impact. This would also help avoid bifurcation of markets into high volume and less-frequently traded products that are costly to issue and invest in.
- Trading book vs. banking book: There are outstanding issues with regards to the trading/banking book boundary. As it stands, the proposal could result in undesired outcomes because the scope of CRR II is broader than the BCBS framework in terms of portfolios that need to be included in the trading book. In addition, a large proportion of syndicated loans that are intended to be held to maturity would need to be kept in the trading book, due to the way these products are defined. This is

⁶ISDA/GFMA/IIF industry FRTB QIS analysis

regardless of the intent to hold the asset until maturity and the fact that it should be amortised according to IFRS9. Banks should be allowed to keep the appropriate parts of their loan portfolio in the banking book to avoid subjecting these loans to market risk framework that is unsuitable for them. The alternative would be to disincentivise loan syndication, part of the wholesale market that is crucial for delivering funding to corporates in Europe.

Correct Drafting Errors

- There is a number of drafting errors in the CRR II text that result in divergences from the BCBS standard. In some cases, these would result in overly conservative capital requirements, as the drafting error would change the way capital charges are combined. We provide our technical drafting suggestions in the **technical support annex**.

1 Background

This section provides background on the role of market risk and capital markets, the development of the post-crisis market risk framework, its capital impact, and the objectives of the FRTB.

1.1 Why do bank trading activities matter to the broader economy?

Wholesale banking activities are fundamental to the functioning of the European capital markets, which facilitate investment across the region. Market-based financing provides many benefits to the European economy:

- It allows capital formation to new and existing industries that want to expand;
- Market-making services mean the costs of capital formation are kept low, and investors are able to sell their assets at an appropriate cost when their portfolio needs adjustment;
- It limits the overreliance on bank funding, and ensures risk is passed on to investors that are most capable of managing it.

In addition, financial services end users such as small mortgage banks and individual mortgage takers, corporates, SMEs and investors are able to access crucial hedging solutions via wholesale markets.

1.2 Objectives of the FRTB

The global financial crisis highlighted shortcomings in the Basel I and II market risk capital frameworks. As a short-term fix, the BCBS developed a series of revisions known as Basel 2.5, which took effect in December 2011. The objective of the changes was to adjust the amount of capital held against trading book risks under internal market risk models, mainly by calibrating the models to a stress period and by including an incremental risk charge to capture both credit migration and default risks in the market risk framework.

Based on BCBS QIS results, the overall impact was a mean increase of 224 % in capital requirements for market risk, with much more pronounced effects on some banks with a higher share of RWAs for market risk in the sample⁷.

While Basel 2.5 dealt with overall market risk capital levels, the BCBS began a more comprehensive review of the market risk framework to address perceived shortfalls, complexity and inconsistencies in the Basel II and Basel 2.5 frameworks. The key objectives have been addressed by:

- Trading book vs. banking book boundary: Internal asset transfers between books need to meet stringent rules in order to limit the ability of banks to move assets from the trading book to the banking book, and vice versa. This is meant to avoid regulatory arbitrage.
- Increase supervisory oversight and scrutiny over internal models: Internal models will be subject to stringent back-testing and a P&L attribution test. These models will be

⁷ <http://www.bis.org/publ/bcbs163.pdf>

approved at a trading-desk level, as opposed to across all trading desks in scope for the model application. This will allow supervisors to address model failures where and when they occur, without moving all of the trading desks onto the standard approach.

- Improve robustness of internal models:
 - The new standards require banks to calculate capital based on the expected shortfall measure, with the objective of better capturing tail risks (or extreme events).
 - The introduction of liquidity horizons in the expected shortfall calculation to reflect the period of time required to sell or hedge a given position during a period of stress.
- A more risk-sensitive standardised approach: The new standardised approach is based on price sensitivities, which is intended to be more risk sensitive compared to the existing standard approach. The objective is to create a credible fall-back to internal models.

2 Impact of the FRTB

Quantitative assessment of the framework's impact has so far taken place at a high level, but the effects are not yet well understood on a product and regional level. There are also areas in the framework that are still largely untested.

However, impact assessments conducted so far by the BCBS and industry indicate the FRTB could result in a minimum 1.4-1.5 times overall capital increase, according to industry studies. That could potentially rise to as much as 2.4 times if firms adopt the standard approach more broadly⁸.

The latest BCBS quantitative impact study (QIS) – based on June 2016 data from a broader set of banks from 22 countries – concluded that the weighted average overall capital increase is higher than what had initially been observed, at 67.2% for 'Group 1' banks, 75.9% for global systemically important banks (GSIBs) and 87.4% for 'Group 2' banks. Such an increase in capital requirements could have a detrimental effect on certain capital markets activities.

This overall increase in market risk capital could mask higher levels for specific regions and products, depending on whether the relevant trading desks receive internal model approval.

It is therefore crucial that the BCBS ensures the overall framework is appropriately calibrated, based on more detailed and thorough analysis through its coherence and calibration initiative.

3 FRTB impact on European markets

An implementation of the current FRTB framework would disproportionately increase capital requirements for banks providing capital markets financing, market-making and hedging services.

⁸ISDA/GFMA/IIF industry FRTB QIS analysis

This is contrary to the broader EU objectives of improving access to market-based finance and reducing overreliance on bank funding through the Capital Markets Union (CMU). The key components of the CMU (capital formation, market-making and hedging solutions) all rely on wholesale bank intermediation. Therefore, it is important to ensure that the implementation of the FRTB does not lead to capital requirements that are disproportionate to the risk involved and stifle efforts to vitalise EU capital markets. Based on the FRTB's objectives to reallocate capital between more liquid and less liquid markets, the framework is likely to weigh heavily on fledgling EU markets and smaller issuances.

As it stands, the FRTB will have an impact on local banks that provide their clients with first-level access to the local and broader European markets, as local banks are usually on the standardised approach for regulatory capital requirements. If capital costs rise, these banks will either pass on the costs to end users, or reduce their offerings – those that become uneconomic – to clients. Based on industry analysis on BCBS's FRTB framework, the new standard approach is particularly punitive for less liquid markets and specific products such as foreign exchange, equities and covered bonds.

The rules could also reduce liquidity in European markets by shrinking the balance-sheet capacity that globally active banks can allocate to the region. Large cross-border banks provide most wholesale services in Europe, attracting capital to the continent from investors around the world, and providing market liquidity and hedging services to local banks, investors and corporate end users. It is therefore important that market-specific issues are addressed in the regulation, and BCBS align the global rules with the EU calibration. This will avoid the risk that divergent home and host country rules create undue impediments to banks that provide liquidity and service their clients across regions.

A reduction in banks' capacity to provide liquidity would impact core EU markets that are critical both from economic and financial stability perspectives. This could lead to an unwarranted cost increase and risk for retail mortgage markets, EU governments, and others.

4 Industry Recommendations

In order to avoid a detrimental impact on European capital markets, the following fundamental shortcomings of the framework need to be addressed. Certain parts of the FRTB's calibration have yet to be fully assessed and understood by the BCBS. The framework therefore needs to be further developed and calibrated in certain areas before it is implemented.

EBA RTSs Timeline

The EBA has been given a mandate to develop the technical standards for CRR II. This includes a definition of the P&L attribution test (PLAT), taking international developments into account. This is sensible, as it allows for more time to understand the behaviour of the PLAT and what guidance and standards will be required at the BCBS and EBA levels.

Even under the most aggressive of timelines, however, the technical standards may not be ready to provide firms with sufficient time to build the models and produce the data to satisfy the one-year data history requirement and for supervisors to review and approve the models.

Assuming an entry into force of the revised CRR in January 2019, the EBA will then have six months to complete the draft RTS (i.e. by July 2019). Several months (probably around six months, potentially more) will then be necessary for the EC to endorse the RTS and for the European Parliament and Council of the European Union to decide whether to object. Assuming an application date of January 2021 (i.e. entry into force plus two years), only a few months (maybe one year, potentially less) will be available for firms to build models and compile supporting data, and for supervisors to process a high concentration of model applications. It will also be challenging for supervisors to process the high concentration of model applications and PLAT results that arrive in this narrow window before the proposed go-live date.

While we support the EBA RTSs in general – and specifically those on the PLAT – more time is required post-RTS completion for firms and supervisors to complete the work required to comply with the PLAT standards. We suggest a minimum three-year implementation period (January 1, 2022 FRTB go-live date).

While the RTSs on the technical model specifications are the highest priority, details on liquidity horizons and potential changes to the capital multiplier will also need to be communicated to the market before the implementation to avoid cliff effects for pricing and capital planning.

Phase-in period

In order to alleviate the expected minimum capital increase of 40–50 % compared to the current market risk framework, the EC's CRR II proposal includes a three-year phase-in period. During that time, the overall capital outcome is multiplied by 0.65. We believe this will allow firms to better manage capital increases during the phase-in period.

However, it is crucial this time is used to better understand the capital impact through further QISs. The objective should be to ensure appropriate calibration so FRTB implementation does not lead to material increases in market risk RWAs. Calibration and methodological changes should apply both at the BCBS and European levels to facilitate the adoption of a globally consistent framework.

P&L attribution test

Under the EC proposals, the EBA is tasked with producing technical standards on the desk-level P&L attribution test, which banks need to pass in order to be able to use internal models for their trading desks. As it stands, the BCBS rules are not yet clear on this issue, and work is still ongoing to clarify and calibrate the standard in order to create the right incentives, so that well-hedged portfolios and well-performing models can pass the test.

This is perhaps the most important outstanding methodological issue in the FRTB framework. If the methodology and calibration of the PLAT is not appropriate, then the majority of trading desks will fail the test and will be capitalised based on the standard approach. This would result in a significant overall increase in regulatory capital, estimated at

2.4 times the current market risk framework (i.e. all desks fail⁹), which would disincentivise banks from committing balance-sheet capacity to making markets and providing risk management solutions.

The capital impact could be even greater. Bank simulations have shown that when only a portion of a bank's trading desks qualify to use internal models and the rest are using the standard approach, the overall capital requirements can often be higher than if all desks were capitalised under the standard approach.

The standard needs to be finalised in good time prior to implementation in any jurisdiction

Non-modellable Risk Factors

The FRTB framework sets strict conditions under which banks are allowed to model various risk factors. This includes a requirement for continuously available 'real' prices, defined as 24 observations per year, with a maximum interval of one month between two consecutive observations. If this criteria is not met, the risk factor is classified as 'non-modellable' (NMRF) and a punitive capital add-on is required.

The industry has expressed concerns regarding the stringent criteria – and particularly the maximum interval – which would inadvertently capture relatively liquid products (e.g. EU corporate bonds). Many markets tend to exhibit seasonal behaviour, with limited trading during the summer months or at the end of the year. Furthermore, 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. This, in turn, will have a negative impact on market-making activities in corporate bonds and will decrease overall market liquidity. This runs counter to the goals of the CMU of developing European capital markets and reducing the reliance on bank funding. It will also make it more difficult for smaller European corporates to obtain market-based funding.

To mitigate these effects, the industry is in the process of working with the BCBS to clarify certain aspects of the rule, and establish best-practice data-pooling solutions to satisfy the modellability criteria. It is essential that data-pooling solutions are allowed in the FRTB. If such solutions are disallowed, liquidity will be bifurcated between high-volume liquid issuances and less-frequently-traded products that may become more expensive to issue and trade.

Any industry solution would involve data sharing, which would require significant system-build by vendors, as well as the development of all corresponding legal provisions. Sufficient time should therefore be allowed for implementation.

Positive Gamma

Recognition of tail risk hedges in the standard approach: A key issue across all asset classes in the standard approach is the lack of recognition of tail risk hedges – or positive gamma – on reducing risk. While many of the improvements in the FRTB for internally modelled

⁹ ISDA/GFMA/IIF publish industry FRTB QIS analysis

capital requirements relate to capturing tail risk, hedging instruments that specifically provide protection against these losses are not recognised under the standard approach, which is counterintuitive. This can cause the ratio of RWAs calculated under the standard approach versus those under the IMA to be very large, which is inconsistent with the FRTB's intended goal of making the standard approach more risk sensitive and creating a credible fallback to the internal models. By not recognising the effect of positive gamma for reducing tail losses for each risk class and/or as a macro hedge of the bank as whole against losses from future systemic stress shocks, the proposed rules undermine the incentive for banks to hedge tail risk.

FX

The FX market is undergoing a fundamental change, with global volumes down by 23% year on year¹⁰. Europe, the Middle East and Africa continue account for approximately 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 FRTB¹¹ will result in further increases in end-user costs as banks withdraw capacity or increase pricing. Unless the rules are recalibrated, this will reduce end-user incentives to hedge long-term economic exposures, which could have a spill-over effect on financial stability.

Three areas of change are required:

- FX calibration should be revisited under the standard approach to avoid a significant cliff effect between the calibration of current internal models and the FRTB internal model and standard approaches.
- The triangle rule must also be allowed. If two currency pairs have a liquid market, this implies a liquid market for the third overlapping pair. For example, if EUR/USD and USD/NOK are both liquid markets; it is possible to trade EUR/NOK via the two liquid USD markets, which implies EUR/NOK is also liquid. While it is important to ensure that EU and European Economic Area markets function without undue costs resulting from poorly calibrated FX spread shocks, it is also fundamentally important that the region's exporters have access to hedging products at appropriate costs. The same rationale should therefore be applied for other currency pairs. For example, a EUR/ Brazilian real exposure may be hedged by a EUR/USD exposure and a USD/ Brazilian Real exposure – hence, the EUR/ Brazilian real currency pair should be classified as liquid.

As it stands, the RTS does not clearly state that the EBA can opine on triangulation. This wording needs to be strengthened to ensure that mandate is clear. 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.

- Under the standard approach, the FX risk factor is defined in relation to the bank's reporting currency. European banks that don't have USD as their reporting currency will be penalised under the current FRTB standard approach, as their own and client-

¹⁰ Euromoney 2016 FX survey

¹¹ Particularly when considered in conjunction with the revised CVA charges contemplated by the BCBS

related FX hedging transactions will attract more capital than banks with USD as their reporting currency. We also note that the beneficial treatment of ERM2¹², and closely correlated currencies in the existing CRR Article 354, is not reflected in this proposed revision of the CRR. There is nothing to replace the existing article. Therefore, unless the text is amended, the CRR will contradict itself.

Interest rate risk

For interest rate risk under both the internal model and standard approaches, preferential treatment is given to a bank's domestic reporting currency. Interest rate risk in a bank's domestic (reporting) currency is considered to belong to the most liquid (10-day) bucket under IMA, and receives a reduction under the standard approach by dividing the risk weight by the square root of two.

These rules will inadvertently penalise banks operating with a significant presence in several EU countries and (home) currencies by creating a barrier to participation in certain EU markets. This is especially the case for the non-euro EU markets. For example, a bank that reports in Danish krone would be able to put DKK interest rate risk in the 10-day liquidity horizon bucket under IMA, while a bank that reports in EUR (even those with a significant presence in the Danish market) would have to put DKK interest rate risk in the 20-day bucket, even though the risk is the same. We believe the rules are at odds with the concept of a single EU market, as they create an unlevel playing field and could directly lead to a reduction of liquidity in these markets.

Covered bonds

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. More than €200 billion of new covered bonds is issued each year, and the market is considered liquid.

In terms of credit spread risk, covered bonds are highly correlated with government bonds rather than bonds issued by financial institutions. Their risk weighting should therefore not mirror the credit risk of the issuing institution but the quality of the assets and the over collateralisation of the covered pool. Based on historic performance, the spread shock of 400 basis points in the BCBS rules is overly punitive. In the EC's proposal, covered bonds issued in the member states receive a beneficial treatment of a 20-day IMA liquidity horizon and a 200bp credit spread risk shock in the standard approach. While the EC's proposal represents an improvement from the BCBS's calibration, the revised risk weights still dramatically overstate the credit spread risk for many of the EU's largest covered bond markets.

Furthermore, the application of a single risk weight to covered bonds that fall within credit quality steps (CQS) 1-3 may not be sufficiently risk sensitive. Additional granularity, and therefore accuracy, could be built into the framework by leveraging the CQS approach. We recommend applying separate risk weights to each CQS [1, 2 and 3], starting at 75bp for CQS 1, and scaling up to 200bp for CQS 3. This would be better aligned with stressed performance and fully capitalises stressed risk scenarios under the FRTB's standard approach.

¹² Exchange Rate Mechanism

Finally, the 3bp PD floor applied to the IMA default risk charge is overcharging for highly rated covered bonds' jump-to-default (JtD) risk.

US agency securities

Similar to covered bonds, the market behaviour for US agency (Fannie Mae and Freddie Mac) secured debt closely tracks sovereign debt yields and the underlying assets. In the BCBS FRTB and the EC's proposal, however, they are classified as unsecured financials. The 500bp standard approach spread shock applied to these securities is overly conservative and needs recalibration in order to avoid damaging the market and EU banks' ability to intermediate in these securities or hold them for liquidity management purposes for their USD portfolios. Likewise, we recommend that the spread shock of 75bp is applied to US agency securities.

Securitisations

The BCBS decided to not allow exposures to securitisations in the trading books to be internally modelled. The EC's proposal is aligned with this position. The new standardised framework requires banks to use the credit risk framework for the calculation of loss given default (LGD), and adds market risk components to ensure potential losses – for example, those stemming from spread risk – are capitalised.

In our view, the final Basel FRTB securitisation rules are risk insensitive, and could lead to significant withdrawal of market-making capacity. Based on industry analysis, market-making in securitisations would become unprofitable at such high capital levels, even if the portfolio turnover and bid/offer spreads could be increased to unrealistically high levels. The main issue in terms of making the framework more risk sensitive relates to the credit risk framework's LGD charge, which is overly punitive and would need to be recalibrated in the credit risk framework to a more appropriate level that is aligned with growth and regulatory coherence objectives.

Government Bonds

Sovereign exposures are held by banks for numerous reasons, including liquidity management and business with clients. 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 BCBS FRTB framework overstates capital requirements for these exposures by: i) introducing a non-risk-sensitive 3bp probably of default (PD) floor in the default risk charge; ii) requiring internal ratings-based LGDs that 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 reducing the liquidity of sovereign debt and increasing funding costs for issuers.

Trading book / banking book boundary

The EC proposal widens the definition of trading book to include all fair-valued assets and liabilities (through the so-called 'presumptive trading book list'), without taking into account whether there is a trading intent associated with such assets and liabilities. We believe the trading book definition should be consistent with the Basel FRTB text published in January 2016, in order to avoid regional differences in the scope of application of the market risk standard. It would be counterintuitive if European banks apply a wider definition of the trading book, whereas their peers in other regions are subject to rules more consistent with

the BCBS FRTB rules. The proposed change to the respective CRR Article is provided in the Annex.

We also note that the proposed change to the definition of collective investment undertakings (CIU) may result in an unintended automatic exclusion from the trading book of third-country equivalent funds and derivatives (such as, for example, third-country ETFs), even where such instruments are held with a trading intent and meet daily price availability or look-through requirements. Such a change will not only impact the scope of market risk rules, but will restrict the recognition of CIUs as eligible collateral for trading book securities financing transactions (SFTs), which is currently available under the existing CRR rules. This may have significant implications, but this rule change has not undergone an appropriate impact assessment. Therefore, we propose keeping the current CRR definition of the CIU without changes (see Annex).

While the industry overall supports the increased clarity on the distinction between trading and banking books in the Basel standards, the EC's proposal to further detail the boundary is expected to bring operational burdens for both banks and national competent authorities (NCAs). For example, the proposed products measured at fair value to be included in the trading book by default will require a major documentation effort by larger banks to prove these products should remain in the banking book. Additionally, these requirements do not align with other regulatory initiatives such as IFRS9. The limitation of traders that may only be assigned to one desk also poses a significant problem for smaller banks.

CRR II shares the shortcomings of the Basel text in forcing banks to include all underwriting instruments in the trading book, regardless of intent. Banks often enter into underwriting commitments with the intention of investing in the instruments being issued, up to a certain limit, and reselling the excess. There should be a presumption that the excess should be in the regulatory trading book, particularly where the instrument is a tradable security, but not the amount the bank intends to purchase for long-term hold. Furthermore, because the word 'underwriting' is not defined, the text could be interpreted as requiring all syndicated lending activity to be included in the regulatory trading book, which is surely not what the regulators intend. Even where a bank underwrites a syndicated loan with the intent of selling it to end investors, the nature of the instrument may make it unsuitable for inclusion in the regulatory trading book. Such an interpretation – to include loans that involve syndication but are held to maturity into the trading book – would not be aligned with IFRS 9, for example.

Public disclosures and regulatory reporting

The industry has noted an increased number of reporting and public disclosure requirements, especially for IMA banks, which are more stringent than the draft requirements previously outlined by the BCBS. The industry would recommend that European policy-makers do not front-run the BCBS when drafting the recommended future reporting and disclosure standards.

In respect of Pillar 3 public disclosures, we would like to stress that the need for granular desk-level disclosures – particularly those of the standardised approach charges at the trading desk level – is not properly substantiated. The type of information that the banks are asked to provide under the amended CRR IMA disclosure requirements belongs to the category of 'proprietary' and 'confidential'. The BCBS rules rightly acknowledge that certain

information, such as “about a bank’s customer base, details on internal arrangements, methodologies used and parameter estimates and data”, is considered proprietary and confidential. Its disclosure may undermine the commercial interests of a bank and jeopardise the competitive advantage that a bank may have in a particular product or market. This goes against the very principles of the Pillar 3 disclosures (as per the Basel Pillar 3 framework published in January 2015).

The industry would therefore strongly suggest excluding such disclosures from the CRR text on the basis of their contradictory nature to the basic Pillar 3 principle of preserving the right to protect institution’s confidential and proprietary information. In addition, granular information will inevitably be less comparable and may result in spurious conclusions about the level of market risk of a bank. Moreover, the correct interpretation of the granular information, including the results of the PLAT and back-testing would require an understanding of technical intricacies of the underlying market risk calculations. That raises the question of the usefulness of disclosures that require specialist knowledge in order to understand and correctly interpret them. Therefore, we suggest that only portfolio-level market risk charges for IMA institutions are required to be disclosed. Detailed comments on CRR articles covering public disclosure of information on an institution’s market risk capital requirements is provided in a separate ISDA / AFME letter.

With respect to additional reporting by IMA institutions to their competent authorities, which is being proposed in the draft CRR amendment document, we note that this is currently not linked to existing COREP framework. We suggest that the following should be re-considered: (i) whether the prescribed monthly frequency may be burdensome on the basis of a cost-benefit analysis; and (ii) whether the frequency of reporting and the formats used should be a subject of either separate RTS / ITS or be incorporated into the existing ITS on supervisory reporting as per Article 99(6).

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