Prudential Banking Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

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Subject: HMT Public consultation: Implementation of the Investment Firms Prudential Regime and Basel 3 standards[1]

The International Swaps and Derivatives Association (ISDA) and the Association for Financial Markets in Europe (AFME), the 'Joint Associations', and their members, 'the industry', welcome the opportunity to comment on the HMT's consultation on the "Implementation of the Investment Firms Prudential Regime and Basel 3 standards".

The Industry remains concerned by certain elements in the Basel III reforms and the significant impact the package will have on capital requirements for specific product and risk categories. The implementation of the Fundamental Review of the Trading Book (FRTB) will materially increase the minimum capital requirements for market risk for banks with market making activities in the UK. While we understand that in the UK this impact may not be as pronounced due to the existing UK specific requirements (Risks not in VaR, Pillar 2), it nevertheless will potentially result in more bifurcation between liquid and less liquid instruments and amplify capital requirements for particular asset classes when the markets liquidity deteriorates. Industry is furthermore concerned that combined with certain elements of Basel III implementation as set out in the PRA's CP5/21, the UK's attractiveness for global derivatives activity could be negatively impacted.

The industry reiterates that consistency in the capital rules implementation is important both across UK institutions and globally across regions, in particular with regards to implementation timelines, and therefore welcomes standards that are aligned globally, but allow for targeted UK adaptations and improvements where necessary.

As part of this consultation response within Chapter 3 for FRTB Standarised Approach (FRTB SA), we have structured our comments into 3 areas;

i. Proposed timeline and Implementation
ii. Areas of Inconsistency and Interpretation Issues with BCBS
iii. Collective Investment Undertakings

[1] https://www.gov.uk/government/consultations/implementation-of-the-investment-firms-prudential-regime-and-basel-3-standards-consultation

i. *Proposed Timeline and Implementation*

The industry has concerns on the process for competent authorities to provide specific authorizations under the FRTB SA. The industry asks that clarity is provided on the timeline, process and potential documentation that might be expected for these authorizations or if a non-objection approach is sufficient for the purposes of FRTB SA reporting. Any guidance would need to be provided in a timely manner given that FRTB SA reporting is anticipated to start in Q1 2022.

ii. *Areas of Inconsistency and Interpretation Issues with BCBS*

As HMT is collecting feedback on the delegated act, the industry notes that in February 2021 the European Commission published a corrigendum[2] which extended the scope of the European delegated act[3]. This corrigendum makes alterations to some areas of CRR2, and the industry believes that HMT should apply these same alterations in the UK regulations pertinent to FRTB.

Furthermore, despite the increased scope of the European delegated act, gaps still remain between the Basel 3 standards and the CRR. The industry believes that where possible UK regulations should align with the Basel standards. To help inform decision-making, a gap analysis has been provided that compares the Basel final FRTB SA standards with the European delegated act and CRR II. Industry suggests that where differences do exist, the Basel standards should be given priority in order to safeguard consistency in implementation at a global level.

Herein this response the Industry highlights certain key areas of inconsistency which have been identified as priorities for remediation in the FRTB SA framework to avoid unintended consequences and disproportional impact.

Finally, we understand that the Market Risk Group at the BCBS may not be addressing further FAQs at this time. To further inform your deliberations we also provide outstanding industry FAQs and working group recommendations related to the FRTB SA which will help avoid inconsistencies in firms implementation plans.

iii. *Collective Investment Undertakings*

The Industry is concerned that various components of this framework raise significant operational challenges. In particular, the SA treatment for equity investments in funds is very punitive (especially when they cannot be fully or partially decomposed). A pragmatic approach is required to help address the operational burden. We recommend alternative approaches in this paper that provide more flexibility.

Beyond FRTB, the industry would like to highlight two additional areas (in respect of Chapter 2) where we seek alignment with Basel standards. In the case of CIU exposures for credit risk, we seek a re-alignment to Basel standards by removing equivalence requirements and in doing so support global competition. With respect to Minimum Requirement for Own Funds and Eligible Liabilities (MREL) requirements, we believe the EU implementation, under article 92b to be inconsistent with FSB TLAC Term Sheet and Guiding Principles of Internal TLAC and urge HM Treasury to remove article 92b and rely on the Bank of England's approach prior to onshoring this article.

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=OJ:L:2021:065:TOC

[3] https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv%3AOJ.L_.2021.084.01.0001.01.ENG&toc=OJ%3AL%3A2021%3A084%3ATOC

We thank you in advance for your consideration and please do not hesitate to contact the undersigned associations with questions or if you would like to discuss our recommendations further. We remain committed to assisting HMT in achieving the objectives of this important consultation.

Gregg Jones
Director, Risk and Capital
International Swaps and Derivatives Association, Inc. (ISDA)
25 Copthall Avenue (3rd floor), London EC2R 7BP
Tel: +44 (0)20 3088 9746
gjones@isda.org

Sahir Akbar
Managing Director, Prudential Regulation
Association for Financial Markets in Europe (AFME)
25 Canada Square, London E14 5LQ
Tel: +44 (0)20 3828 2732
sahir.akbar@afme.eu

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Chapter 2. Implementing the Basel 3 standards: Exercise of the Clause 3 revocation power

Box 2.A: Implementing the Basel 3 standards: Exercise of the Clause 3 revocation power

1. Do you have any comments on the value of keeping this equivalence provision in Article 132 of the UK CRR?

Response:

Collective Investment Undertakings

Industry would like to highlight some points concerning CIUs (Collective Investment Undertakings) and the issue of third-country equivalence relevant to the standardised approach for credit risk and large exposures.

We welcome HMT taking a pragmatic approach to implementation of the new hierarchy of approaches, however we urge the removal of the standalone equivalence requirement. Re-alignment with the Basel standards and removal of the equivalence requirement for these CIU exposures would support global competition. The third country restrictions do not solely impact investments but also collateral positions.

In the first instance, if equivalence is retained then it is imperative that key jurisdictions are assessed for equivalence ready by 1 January 2022 in time for implementation of the new framework. There is a risk of unintended cliff edge effects as banks manage investments to avoid attracting a 1250% risk weight in the period where equivalence assessments are not ready.

Where necessary, and/or as an interim step, the PRA could require banks to make 'case-by-case' equivalence assessments using independent third party assessment. The bank would incur the cost of doing the assessment, and this is an approach that has been previously used with the UK regulators for other exposures.

Currently, HMT's CRR 132(3) equivalence table solely references the EEA as an equivalent jurisdiction. This is very restrictive. In the absence of broader third country recognition, we would urge HMT to widen this and prioritise assessment and inclusion – in no particular order - of Australia, Canada, China, Hong Kong, Malaysia, Mexico, Singapore, Switzerland and the United States. We would appreciate clarity on timelines for planning purposes.

We also believe that specific treatment should be introduced in relation to investments that are made to satisfy Government requirements (for example investments under the Community Reinvestment Act in the US) or investments which support Government endorsed investment programmes (for example the Business Growth Funds in the UK, Canada and Australia). These may not qualify as legislative programmes within the definition of the Basel standards but are nevertheless investments intended to support Government objectives.

Additionally, on another point of clarification, we would also note that in Rule 7 in section 5 of the new large exposures CRR part of the rulebook provides conditions where the structure of a transaction shall not constitute an additional exposure (i.e. look through is not required). One of these conditions covers measures designed to prevent the redirection of cash flows away from the transaction to persons who are not entitled to receive them and sets out that UK UCITS's and similar structures in an equivalent third country are automatically assumed to meet this condition. We assume that the equivalence provisions for CIUs in Article 132 are relevant here however we would request that HMT explicitly state this in their list, and/or that the PRA makes the minor amendments to their wording (page 131, PRA Rulebook (CRR) Instrument 2021) to clarify which equivalence decisions are relevant here.

As a final point, the trade associations note that many of the same issues (particularly issues around regulatory equivalence) that arise in the calculation of credit risk for banking book CIUs also arise in the calculation of market risk (including the traded default risk charge) for trading book CIUs which will form part of the delegated act referred to in Chapter 3. In order to avoid perverse incentives for firms to assign CIUs to one book or the other, the ability to qualify for a more favourable capital treatment (such as look-through) should be as consistent as possible.

Eligible Liabilities

In Chapter 2 of HMT's consultation paper, a departure from the EU's CRR2 approach on eligible liabilities is proposed. A related area where the existing CRR2 provisions are not consistent with the applicable global standards is article 92b CRR2. We view this provision as inconsistent with the Bank of England's 2018 MREL Policy Statement (SoP) and the FSB TLAC Term Sheet and Guiding Principles of Internal TLAC which provide for internal TLAC requirements to be set at 75-90%[4].

Prior to the onshored article 92b CRR2, internal MREL was calibrated by the Bank of England in accordance with the SoP in line with the TLAC standard and we view this as an appropriate area where the Bank of England is best placed to establish internal MREL requirements as part of the UK resolution framework. The Bank of England's SoP states that "By setting internal MREL, the Bank will also implement the Financial Stability Board (FSB) Total Loss Absorbing Capacity (TLAC) standard" (see para 1.7).

Article 92b CRR2 is unduly prescriptive, reducing the Bank of England's flexibility to achieve its policy outcomes in consultation with home authorities. With respect to calibration, the Bank of England sets internal MREL requirements in the 75 to 90% range of the full amount of external MREL requirement, as agreed at international level. This provides an important mechanism to authorities and incentive to firms to encourage coordination and progress across jurisdictions. In contrast, Article 92b sets a fixed scalar at the upper bound of the range. In addition, prescriptive restrictions with regards to issuance paths in Article 92b(2) are unnecessary and redundant. Different paths should be able to be considered by firms and by the resolution authority, as long as losses can effectively be absorbed and passed up to the resolution entity. The Bank of England's existing approach is consistent with this principle (see SoP, para 8.4). It should also be noted that the Bank of England already has powers to

[4] https://www.fsb.org/wp-content/uploads/TLAC-Principles-and-Term-Sheet-for-publication-final.pdf ; https://www.fsb.org/wp-content/uploads/P060717-1.pdf

issue directions to firms if it considers that the issuance path of MREL/TLAC constitutes an impediment to resolvability.

Finally, the Associations note that inconsistencies in requirements creates confusion among investors and stakeholders, rather than supporting the Bank of England's objective to increase transparency in the resolution process, as set out in the Resolvability Assessment Framework. As a result, the Industry recommends that HMT further allow departure from the EU's CRR2 approach on eligible liabilities by removing Article 92b.

Chapter 3. Fundamental Review of the Trading Book

Box 3.A: Fundamental Review of the Trading Book

2. Do you have any comments on HM Treasury's proposed timeline for the implementation of these regulations?

Response:

The implementation of the FRTB needs to be considered in conjunction with market liquidity and market-making activities of banks - both are crucially important to the functioning of financial markets. The PRA & HMT need to ensure that the implementation of FRTB in the UK and the impact on banks' market making activities is not further exacerbated by an inconsistent implementation timeline in key financial centres across the world.

The post-Brexit landscape also means that UK banks will need to consider in their implementation program any deviations from the EU timelines and rules. In some cases it will require them to have different reporting mechanisms for their UK & EU entities. Having clarity on timelines is important for banks to appropriately plan the implementation build.

Even a small change to banks' SA implementations to meet UK-specific requirements is likely to require extensive testing and internal review, meaning that the rules need to be in a final, implementable form at least 6 months before the first close of business date banks report FRTB SA; this would mean the regulations would need to be finalised in time to accommodate the first reporting date at the end of Q1 2022.

The timetable becomes particularly tight if banks are expected to apply for "SA permissions" such as use of alternative sensitivities – if there are to be permissions in place by Q1 2022, banks will need to submit applications to the PRA in 2021. This in turn means that the proposed delegated act will need to include the necessary information on the expected form and content of such applications as early as possible to allow firms to operationalize their FRTB SA reporting functionality.

The current timelines are therefore significantly challenging and may not leave enough time for banks to submit their relevant applications. We recommend that the SA permission requirements should be waived until the SA becomes a binding capital requirement.

Furthermore, we recognise that some FRTB SA Authorizations have already been onboarded through the CRR2, however there some authorizations are being proposed to be onboarded through the delegated act from the HMT. We list in the table below the different authorizations and which are associated with this delegated act under consultation or have otherwise been onboarded through the CRR2.

ID	Approvals required as part of the FRTB SA	Reference	CRR2 vs DA
1	Permission to include non-option trades in the SA curvature charge	DA 325e(3)	DA
2	Use of a base currency other than the reporting currency for FX delta and curvature	DA 325q(7)	DA
3	Switching from look-through to non-look-through and vice versa after initial go live	DA 325i (4)	DA
4	Permission to use the mandate-based approach to calculate own funds for CIUs	DA 325j (1bii)	DA
5	Permission to use a tracked index benchmark approach, pending authorization where an annualised return difference uses a period shorter than 12 months	DA 325j (2)	DA
6	Permission to use the 'scalar approach' and divide instrument level SBM curvature requirements by 1.5	DA 325q (6)	DA
7	Calculation of net positions and own fund requirements on a consolidated basis	325	CRR2
8	Alternative definition of sensitivities	325t (5) and 325t (6)	CRR2
9	Use of a reduced FX risk weight for currencies pegged to EUR	325av(5)	CRR2

We strongly recommend that HMT use this opportunity to reduce the operational burden to banks by not explicitly defining the approaches listed above to require an approval from the PRA. Banks would be prepared to support their decision to choose an alternative approach and to substantiate this by providing appropriate documentation to the HMT/PRA if required to do so.
Alternatively, where HMT considers that a defined authorisation approach is required, we would welcome the opportunity to engage and provide our feedback on the documentation that could be provided to help support an efficient approval process. We also recommend that existing permissions for the calculation of net positions on a consolidated basis under CRR Article 325b are 'grandfathered' for the purposes of SA reporting.

We also note that CRR2 articles 325ae3 (most liquid currencies for GIRR), 325ap2 (definition of "large cap") and 325av4 (most liquid FX currency pairs) create a dependence within the *SA* on the BTS for *IMA* liquidity horizons. The UK's implementation of the SA is therefore not functionally complete without the UK version of this BTS. In particular, based on earlier communication from the HMT[5] we expect some divergence from the EU definition of large cap equities.

[5] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/927316/141020_Final_Phase_II_Condoc_For_Publication_for_print.pdf

3. The EU Commission adopted the delegated act referred to above on 17 December 2019. Do you have any comments on the form these regulations should take in the UK?

Response:

I. Basel & CRR Inconsistencies

The UK implementation should be aligned with Basel in preference to CRR2 where there are meaningful differences. The Treasury is not bound by the same limitations as the European Commission when it comes to the scope of the delegated act, and industry believe it would be a good opportunity to fix errors and align with Basel where appropriate.

a. FX Vega

Background

For FX Vega, Basel Standards do not refer to the exchange rates between the currency in which an instrument is denominated and the reporting currency. There is also no reference to the base currency approach for FX Vega. The buckets for FX delta are for currency pairs $CCY_{instrument}$ / $CCY_{reporting}$ but by convention they are written as a single currency $CCY_{instrument}$ and the reporting currency is taken as given. As for FX delta, the buckets for FX vega are for currency pairs $CCY_{instrument}$ / $CCY_{instrument}$ and are written as such.

Issue

CRR2 Article 325 q is not in line with Basel standards. In Article 325q (1), FX delta risk factors are the exchange rates between the currency in which an instrument is denominated and the institution's reporting currency or the institution's base currency. In Article 325q (2), the same constraint applies to FX Vega risk factors. The Basel Standards reference currency pairs and does not require the exchange rates between the currency in which an instrument is denominated and the institution's reporting currency or the institution's base currency.

The Basel Standards represent risk management practice and avoid the artificial triangulation. Trades are priced using volatility surfaces of currency pairs. To implement the triangulation to reporting/base currency, institutions would need to make assumptions on correlation and model this.

Furthermore, the Basel III monitoring template for FX, Delta risks are requested by Currency as the Reporting currency can be different across firms and Vega risks are requested by Currency pair.

Industry Recommendation

The industry recommends to update Article 325q, point 2, which defines the FX risk factors for Vega in order to remove the reference to paragraph 1. The FX Vega risk factors should be the implied volatilities of exchange rates between currency pairs.

b. Correlation Trading Portfolio

Treatment of credit index, buckets and intra-bucket correlations for credit spread risk for securitisations included in the ACTP.

The current rules around CTP are ambiguous and, depending on interpretation, can result in very different capital outcomes. In particular, article 325i(1)(a) specifies that for Credit Spread Risk (CSR) Securitisations in the ACTP, indices and index tranches must not be decomposed in single name exposures while non-index tranches (bespoke tranches) may.

When an ACTP index is not looked-through, the bucket to which the index should be mapped is unclear for risk weight and aggregation purposes as no index buckets are introduced contrary to the SbM for non-securitisations. This lack of clarity could result in limited comparability between banks. Thus, to make the reporting requirement operational, either look-through should be allowed for ACTP SbM treatment consistent with CSR non-securitizations and / or guidelines should be published to specify the intra-bucket correlations and risk weights for credit indices in the ACTP that are not looked-through.
The industry believes that the allowance of look-through approaches across SbM and DRC within CTP are essential in order for the rules to be economically meaningful and technically consistent and will formulate a more comprehensive response to the consultation by the UK regulators on its Basel III implementation.

c. Credit Spread Risk Non-Securitisation (CS_NS) buckets, risk weights and correlations

- **Buckets and risk weights**

Article 325ah introduces additional buckets for Credit Spread Risk Non-Securitisation causing the bucket numbering to be misaligned with International standards, e.g. financial sector entities are bucket 3 in BCBS d457 but bucket 4 in the delegated act. Industry sees no benefit including additional buckets with very limited impact overall. The divergence from the BCBS d457 bucketing structure is unwelcome and creates an operational burden for institutions operating in multiple jurisdictions.
The proposal is to align to BCBS d457.

- **Correlation within the same bucket**

The correlations applied within the same bucket for Delta CSR non-sec are different between CRR2 (Article 325ai) and BCBS (MAR21.55). CRR2 requires the use of 35% while BCBS requires the use of 80%.
The industry recommends aligning the correlation to the one prescribed in BCBS (MAR21.55) **, i.e. 80%.**

- **Correlation across buckets**

The correlation applied for the aggregation of sensitivities across buckets for Delta CSR non-sec are different between CRR2 (Article 325aj) and BCBS (MAR21.57). CRR2 correlations require the use of 50% correlation for index buckets (19 and 20) and 1 for all other buckets (1 to 3 or 4 to 6) where BCBS requires the inverse.
The industry recommends aligning the correlation requirement to BCBS.

d. GIRR Delta Risk Weights

CRR2 (Article 325ae) excludes risk weight reduction for inflation and cross-currency risk factors. CRR2 provides a scaling by square root of 2 only for risk-free curves whereas for BCBS (MAR21.44), the scaling

factor can be applied to all GIRR risk factors, including inflation and cross currency basis. The most liquid currencies specified in the EBA RTS are the same specified in BCBS.
The industry recommends that the risk weight reduction for GIRR should be aligned to the BCBS requirements and should apply to all three risk factors under GIRR (risk free rate, inflation and cross currency basis).

e. Position without optionality in calculation of Curvature Risk

By default, instruments without optionality are only subject to own funds requirements for delta risk for the non-exotic underlying(s) of the instruments, but not for curvature risk. Nevertheless, the BCBS text provides discretion for institutions to subject all instruments, including those without optionality, to the own funds requirement for curvature risk. This discretion could be helpful for institutions that manage and hedge positions with and without optionality together.

The industry is concerned that the discretion as worded in Article 325e of the CRR will be narrower than under MAR21.2(4). Banks manage and hedge positions with and without optionality together for some products, asset classes and business lines but they do so on a case-by-case basis based on their internal risk management approach. Industry's reading of MAR21.2(4)(b) is that it allows firms to manage and hedge positions with and without optionality together for some products, asset classes and business lines but not all of them, based on consistently applied risk management practices. To reflect this in the delegated act text we suggest the following drafting for Article 325e(b):

> *(b) the following paragraph is added: '3. By way of derogation from point (b) of paragraph 2, an institution may choose to subject all the certain positions of instruments without optionality to the own funds requirements referred to in points (a) and (c) of paragraph 1 based on consistently applied internal policies subject to clearly set out internal governance standards to prevent the use of this discretion to be used primarily for the reduction of own fund requirements. Competent authorities may inform the institution at any time that the institution is no longer permitted to apply this derogation.*

In line with the requirement to clearly document inclusion of curvature risk on certain linear products, the industry believes that there is a need to ensure the discretion is not used to primarily reduce own fund requirements. However, we suggest that a notification requirement of three month is overly prescriptive. Competent authorities should be able to rely on the institution to introduce controls to ensure the derogation is applied consistently and without primarily reducing own fund requirements.

f. Use of a base currency

The BCBS text includes a 'base currency' approach that can be used as an additional method to determine the own funds requirement for delta and curvature risks for foreign exchange risk factors. Under this approach, institutions would be able to choose another currency than their reporting currency to express the foreign exchange risk factors.

The allowance to define FX risk factors with respect to a base currency different from the reporting currency is a welcome development as it will help mitigate the double counting effects for banks that are typically trading FX rates against one predominant currency (different from the domestic/reporting currency). For banks that trade many currency pairs (reflective of more worldwide client's needs) without a distinct pivot currency, effective mitigation of the double counting of risk can be achieved through the provision specific to FX curvature via the 1.5 re-calibration in the FRTB standard. Furthermore, in instances where the group's reporting currency differs from the local reporting currency (for subsidiaries or branches for instance), the group reporting currency can be the ideal candidate for the choice of base currency under the FRTB/CRR2 rules as using it as the base will reduce the operational burden to generate "additional" FX sensitivities for local reporting.

g. Article 325aq

Article 325aq of the consultation paper does not fully document the requirements for intra-bucket correlations as per MAR21.79(2). Kb of other sector bucket is simply the max sum of negative curvatures under up/down scenarios, but it is not clearly stated in Article 325aq. Article 325aq(3) carries over the typo in MAR21.78(3) which refers to sub paragraphs (a) to (d), not reflecting addition of new sub paragraph (e).

II. Collective Investment Undertakings

Treatment of funds under FRTB SA is problematic due to the reliance on Look-through approach in order to have an adequate capital treatment, as it introduces a computational intensity comparable to the IMA. The other two alternatives, the Mandate approach & Fallback approach, offer a risk representation that doesn't match up to the actual risk of the products. Moreover, the Fallback approach is only available if a bank has access to the fund's mandate (in order to verify that the DRC is conservative), meaning it is not a reliable fall-back.

There is a disconnect between the regulatory implications and the real risk of well-diversified funds. The EU has onerous requirements for funds that may be in place to mirror the existing framework for UCITS funds. However, from the perspective of the UK regulator, it may be useful to diverge from these restrictive requirements, as the added layers of protection are not relevant to the needs of funds in the UK. This is particularly true in the context of London-listed closed-ended investment companies (which are unique to the UK), where regular disclosure and risk diversification are regulatory prerequisites.

In the below response, we examine some of the conditions that make each of the CIU approaches deficient, and propose a few suggestions that would, in the first place, ease the pressure of excessive operational complexity and in the second place, offer alternatives to the prescribed approaches.

a. Look-Through Approach

The complexity of the Look-Through Approach resides in:

- Obtaining all the fund composition information in a timely manner.
- The computational effort required to re-evaluate thousands of risk factors (especially under SA, where there needs to be a sensitivity for each risk).

It is a source of concern that the current formulation of the Look-Through approach will impose an unprecedented operational burden on Banks:

- An equity investment in a fund can contain up to several thousand components and it will be impossible to book them monthly to compute the required sensitivities for the Sensitivities-based Method (SbM) or the Jump-to-Default (JtD) for the Default Risk Charge (DRC),
- Institutions will encounter components of equity investment in Funds that they do not trade actively. Consequently, they will face system limitations in terms of booking, pricing libraries, reference, data framework etc.
    - Example: Corporate loans and structured finance bonds are components of a large part of European fixed income CIU. Such products are usually not priced directly by banks due to the significant workload required to price just one asset and the vast number of issued bonds / loans. Instead, banks usually use external / market-place solutions.
- Booking of all the components will introduce a very high degree of operational risk which may lead to low reliability of the results and will result in additional risks for banks' trading activity (e.g. stale reference not necessarily up-to-date).
- Similarly to the Mandate Approach, the Look-Through Approach will require that any derivative trades be included in the CVA and SA-CCR calculations. It is not possible to source counterparty information for the CIU positions.
- Some CIUs may contain a small percentage of alternative assets, such as real estate, which are not permitted in the Trading Book. It will be very difficult to manage the split of constituents within the CIU constituents across the different books between the Trading Book and the Banking Book.

Industry recommendations

Additional clarity and some pragmatic flexibility should be introduced for the SA look-through approach, **allowing banks to use sensitivities to underlying fund's components provided by third parties**. The PRA already applies similar guidelines as those used for insurance companies under the CIU Look-Through Approach[6], namely:

- The PRA will accept look through reporting based on best available data and approximations, provided firms are able to demonstrate to supervisors (if asked) that the approximations are reasonable after taking materiality into account.
- The best available data may include the most recent investor information available, where it is impracticable to get data as at the regulatory reporting reference date.
- The above points hold provided that data is not stale (for example, where the difference between dates is not more than, say, 3 months) and adjustments are made for any significant events or transactions in the intervening period.

Applying these guidelines, while not completely remediating the operational burden on banks, will at least offer some relief in terms of the practicability of the Look-Through Approach.

It is important to note;

- The sensitivities requested from the third party would not depend on banks' own positions. Indeed, for each component of a given equity investment in a CIU, institutions would need from the third party the sensitivities to interest rate, FX, equity, credit spread and commodity risk factors expressed

[6] Basis of preparation for look through approach for Collective Investment Undertakings – Template S.06.03. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/regulatory-reporting/insurance/basis-of-preparation-look-through-reporting-s0603.pdf?la=en&hash=6848E655A8623E0FCA31219FBDE6A8839EE79018

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as sensitivities on the fund NAV. Then, based on these provided NAV sensitivities, additional information on each component - useful for the bucketing of the SbM for instance - and their own pricing libraries, institutions would be able to compute the SA with a Look-Through Approach.

- The technology required to calculate funds' NAV sensitivities has already been developed by CIU management companies to meet the needs of insurance companies regarding the market Solvency Capital Requirement (SCR) computation in the context of Solvency II (Appendix 3)
    - In the case where these sensitivities do not perfectly match the Basel requirements in terms of the shock's level, some upper bound proxies could be introduced to ensure a conservative level of capital requirements.
    - Exposures due to components that cannot be treated in a consistent manner along with the two previous items, could be allocated to the Equity 'other' bucket and dealt with on a stand-alone basis.
    - Where the funds' data is generally less frequent than daily, the Look-Through Approach could still be permitted, possibly by applying some kind of materiality or other criteria (as per the PRA's guidance to insurance companies).

However, the Industry recommendation is based on preliminary data from a subset of banks; NAV sensitivities may not be available in all jurisdictions and for banks whose UCITS fund portfolio does not have the adequate scale to obtain this data from asset managers. Further investigation into this matter is required in order to assess evidence of the availability of this data for a larger set of banks.

b. Mandate-Based Approach

The "Mandate-based" representation of funds poses conceptual concerns:

- Given the quite high-level description of the investment strategy it provides, the hypothetical portfolio that could be constructed out of its mandate would be a much less diversified (a handful of constituents) - and by construction of much lower quality - representation of the original fund.
- Considering a fund that might be made up of hundreds of instruments, it is clear that casting its volatility into the volatility of a portfolio of the four or five constituents of the lowest quality allowed by the Mandate will result in a material misrepresentation of its riskiness.
- This is even more of a concern for the default risk simulation (DRC) in which the Fund's high diversification will effectively result in a limited erosion of its value due to default events. This would clearly be not the case for a hypothetical portfolio constructed out of its mandate.
- The standalone capitalization of the hypothetical portfolio provides additional conservativism to a representation that transforms one of the most diversified products in the market into a low-quality, poorly diversified portfolio.
- The use of hypothetical portfolios also attracts some requirements around the calculation of CVA and CCR charges on "the derivatives of this hypothetical portfolio". This implicitly means that such hypothetical representation of the fund should also be fed to CCR and CVA calculation engines, i.e. workflows and systems that are completely independent and detached from the Market Risk framework. Establishing such links will be extremely complicated and costly and even more so if one thinks that there is no requirement for a look-through representation of Funds under these frameworks.

The Mandate Approach appears impractical to set up and maintain (creation and maintenance of the hypothetical portfolios that should be inferred from the language used in the mandate) and conservative to an extent not too dissimilar from the last level in the waterfall: the assimilation to an "unrated equity".

Industry recommendation

IMA should not include the mandatory look through requirements, instead it should be acceptable for CIUS to be included in IMA as a single risk factor using the daily liquid price of the CIU.

c. Fallback Approach

Regulated funds are relatively low risk and therefore fund positions, when not looked-through, should be assigned low risk weights. Besides, the framework should recognise a diversification benefit across fund exposures. Both the mandate-based and "single equity" approaches do not allow any diversification and instead capitalise each fund position on a standalone basis. The 'single equity' approach is particularly impacting for the business of options on CIUs given the magnitude of shocks in the curvature calculation (-/+70%). Forcing non-look-through regulated funds (e.g. UCITS funds) to be capitalised in the SA in a very conservative way will simply force banks to stop providing market making services, thus blocking investor access to funds or derivative products referencing funds as underlying.

Industry recommendations

One way to appropriately address those issues would be, in the SbM, to create additional risk weights (Equity and Debt funds) dedicated to non-look-through funds with commensurate risk weights and diversification justified.

In addition, some consideration might be given to the different types of funds – such as closed-end funds which trade on exchanges as a listed equity, versus open-ended funds which are unlisted. For closed-end funds, pricing and liquidity is independent of the fund. With regards to such funds, the unintended consequence of overly onerous regulation could well mean that market makers are forced to withdraw from the market, resulting in less liquidity and greater volatility for the investor.

d. Equity investments in CIUs that track an index

The delegated act treats positions in a fund that tracks a listed index sufficiently well as positions in a single equity, instead of a position in the tracked index, thereby not allowing any netting of tracker funds/ETFs with their index benchmarks, which would create a significant capital impact for activities in these products. Furthermore, the delegated act considers only listed indices as eligible benchmarks.

This is a significant divergence from the Basel text MAR21.35(2) and MAR21.36(1) which treats such positions as positions in the tracked index, where not only listed benchmarks are eligible. Hence, the delegated act limits the scope of funds eligible tracking treatment and recognises much less netting than the Basel text. This inconsistency may be remediated by expanding the scope of alternative treatment for fund trackers, and by changing how eligible funds are represented as an exposure (see recommendation below).

Additionally, the Basel text allows “large index” (as defined in 325(i)(3)) holdings in funds to be exempt from the “look-through” approach MAR21.35(1), where Article 325j(1)(a) seems to make the full decomposition mandatory, even for fund holdings in large indices. This is a divergence from the Basel text that will add operational complexity for diversified funds. We suggest reflecting this provision of the Basel text in the delegated act, and retaining the same approach (look-through or non-look-through) between tracker funds and their tracked benchmark.

We would also recommend allowing tracking funds to be modelled under the Internal Model, when held on an Internal Model desk, and treating them as holdings in the tracked benchmark.

Industry recommendations

To allow for recognition in the delegated act of netting of tracker funds/ETFs with their index benchmarks, we suggest that it should better reflects the Basel text as follows:

- The alternative treatment for fund trackers is not limited to those tracking a listed index, as long as the composition of the benchmark is available with sufficient frequency.
- When a fund is eligible for the tracking treatment, it should be represented as an exposure in the tracked index.

Additionally, industry suggests that the delegated act reflect the treatment in MAR21.45(1), which allows “large index” holdings in funds to be exempt from the look-through approach.