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January 6, 2014

Norah Barger & Alan Adkins, Co-Chairs, Trading Book Group
Ju Quan Tan, Member of Secretariat, Basel Committee on Banking Supervision
Basel Committee on Banking Supervision - Bank for International Settlements
Centralbahnplatz 2, CH-4002 Basel, SWITZERLAND

Sent by email to: alan.adkins@bankofengland.co.uk; norah.barger@frb.gov; Juquan.Tan@bis.org; baselcommittee@bis.org

Subject: Request to Revise the FRTB and QIS Timeline

Dear Ms. Barger and Mr. Adkins,

The undersigned Associations appreciated the opportunity to meet with the Basel Committee's Trading Book Group (TBG) on December 10 to discuss the second consultative document on the Fundamental Review of the Trading Book (FRTB).

While we intend to provide the TBG with detailed comments on the proposals by the consultation deadline of January 31st, we decided to write to you at this time to convey our concerns that the announced timeline[1] for the industry to run Quantitative Impact Studies (QISs) and for the FRTB to be completed by the TBG is insufficient, given the wide ranging objectives of the TBG. This is a further iteration to our previous letter to the Co-Chairs and Wayne Byres and reflects our greater sense and understanding of the level of work required in terms of completing the framework and ensuring that firms have the technical capability to be able to participate in the QISs in a meaningful way.

Firstly, we want to assure you that we very much support the objectives of the TBG and we view the FRTB as a great opportunity to review and strengthen the methods used to define minimum regulatory capital requirements for traded market risk.

Secondly, we note that the level of regulatory capital required for the trading book was materially increased (multiplying it by several times compared to its prior level) by the Basel 2.5[2] framework. As noted in the June 2012 and October 2012 report to the G20 leaders, the revisions introduced in Basel 2.5 were "in response to lessons from the financial crisis" and as required by the G-20 mandate[3]. Based on the most recent August 2013 report to the G20 leaders, Basel 2.5 has largely been implemented globally. Basel 2.5 was then supplemented by Basel III, via capital requirements for counterparty credit risk (e.g. CVA VaR) and the new overall capital buffers.

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[1] At the December 10th meeting the joint trade associations were told that the TBG planned to have banks run two QISs, using both the internal model approach (**IMA**) and standardized approach (**SA**), on: a) the second set of SIG-TB trading benchmark portfolios in the February-April time period and b) each bank's full trading book in the July-October time period, in order that the TBG could complete the FRTB no later than mid-year 2015

[2] By Basel 2.5 we refer to the package of papers issued by the Basel Committee in July 2009 that updated the regulatory capital framework for market risk.

[3] As noted by BCBS: "As an important response to the crisis, the Committee introduced a set of revisions to the market risk framework in July 2009 (part of the "Basel 2.5" rules). These sought to reduce the cyclicality of the market risk framework and increase the overall level of capital, with particular focus on instruments exposed to credit risk (including securitisations), where the previous regime had been found especially lacking."

Therefore, while we do not presume to specify the appropriate level of regulatory capital required for the trading book, we conclude from the above and from our previous conversations with the TBG that the short timeframe for completing the FRTB is not being driven by an assessment by the Basel Committee (BCBS) that it needs to materially increase the overall level of minimum regulatory capital for the trading book; nor by shortcomings in the market risk capital framework that require immediate attention.

The changes proposed within the FRTB are indeed fundamental, and would require major construction work within firms before a meaningful QIS can be conducted. Furthermore, given the scale of the changes, we want to ensure that we do not arrive at suboptimal final rules with undesirable outcomes by rushing the process, thereby missing the opportunity to fundamentally strengthen the trading book framework.

For these reasons, and the reasons set out in the Appendix, we believe that expanding the time that is scheduled for the completion of the FRTB is crucial in order to enable the industry and the TBG to work together in a constructive, iterative process to achieve the TBG's objectives of the review.

Finally, in the appendix to this letter, we have enumerated in more detail the reasons for requesting a material change in the timeline that has been scheduled for running the QISs and completing the FRTB:

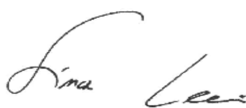
- **We believe that the fundamental changes that the FRTB aims to introduce require an iterative process to ensure that the right and intended outcome is achieved;**
- **The planned QIS timeline for the proposed Standardised Approach (SA) is inadequate, given the significant work required to build functionality to run calculations within a completely new framework;**
- **Due to the material changes in the proposed Internal Models Approach (IMA), the planned timeline for the QIS is not sufficient;**
- **The joint trade associations have been given a very short timeframe to formulate and submit robust counterproposals to key components of the IMA and the SA; and**
- **Finally, the industry would like the opportunity to work with the TBG in refining the framework and designing and launching the QISs, noting that this iterative process will take time.**

In light of the industry's forthcoming counterproposals, and the need for sufficient time to further refine them, we recommend that the TBG defers its first QIS on the FRTB until the TBG has had the opportunity to evaluate and integrate the industry's recommendations into the SA and IMA proposals as it deems appropriate. Then an iterative process could begin, with sufficient time set aside for banks to build the infrastructure needed to run each QIS; we have expanded on this in the appendix.

The industry appreciates your consideration of the proposed extension (see appendix) of the FRTB timelines and we remain at your disposal in the development of the new trading book framework.

As a matter of courtesy, and in order to highlight our material concerns regarding the timeline, we intend to send a similar letter to the BCBS Chairman, Stefan Ingves.

Yours faithfully,



George Handjinicolaou, Ph.D	Simon Lewis	Kevin Nixon
Deputy CEO and Head of ISDA	CEO	Managing Director
Europe, Middle East and Africa	GFMA	IIF

Appendix: Industry concerns relating to the QIS process and the FRTB:

The following are our main concerns about the QISs and FRTB timelines:

- **We believe that the fundamental changes that the FRTB aims to introduce require an iterative process to ensure that the right and intended outcome is achieved.**
    - The FRTB proposes fundamental changes to the current IMA and SA, which represent a significant departure from current industry practices and thus require careful examination and calibration. The industry believes the extent of the proposed changes in the FRTB are similar in terms of scale and complexity to those put forward for credit risk capital under the Basel II framework, which was subject to several formal consultation papers and up to as many as six QISs. We believe a similar iterative process of policy making combined with calibration and recalibration should be adopted for the FRTB. This iterative process will be required since calibration issues will arise as QIS work is performed. Moreover the sheer complexity of the QIS task will be better addressed by considering product/portfolio segments rather than large aggregate portfolios. It is possible that a narrow scope QIS on simpler products could be done earlier (within 6-9 months) while more complex issues around multiple liquidity horizons, non-linearity impacts on large shocks etc. and standard rules re-working may take more time.
    - Given these fundamental changes to the framework, we do not believe that sufficient time has been given to the industry to develop the necessary tools to engage appropriately and responsibly in any FRTB QIS efforts on the timeline proposed.
    - We also note the very rational encouragement – which is explicitly communicated by the TBG in the second consultative paper on the FRTB – to have as broad a spectrum of banks as possible partake in the QIS. This notion appears to be in a direct contradiction with the set timelines that would enable only a small proportion of banks to participate in the QIS. We believe that it is essential to have a wide range of banks with trading businesses involved in the QIS, especially due to the considerable emphasis which is put on the calibration of the requirements and how they apply to different desk structures and instruments with varying liquidity characteristics.
- **The planned QIS timeline for the proposed SA is inadequate, given the significant work required to complete the SA framework and that some identified issues of the framework need to be corrected for.**
    - As explained by the joint trade associations at the December 10th meeting, the proposed SA would require banks to build an extensive parallel infrastructure purely for the purpose of calculating the standardized regulatory capital requirement. The infrastructure would consist of:
        a) Yield curves and calculated Option-Adjusted Spreads (OAS) for each debt security, forward FX, and all other derivative contracts, different to those used for pricing today;
        b) Different processes to calculate the Present Value (PV) of all future (fixed) cash flows of debt securities, forward FX, and all other derivatives, which could be located across various systems and geographical locations;
        c) Processes to map the interest rate risk of each forward cash flow to regulatory-specified tenor buckets, and processes to map other risk factors to other type of buckets; and
        d) Processes to aggregate all current and PV'ed cash flows for each type of risk factor and currency, in accordance with regulatory specified rules.

- As discussed and as acknowledged by the TBG at the December 10th meeting, the proposed SA is still under development as for example it currently ignores all floating rate cash flows. This will make the regulatory capital calculated during a QIS based on the proposals irrelevant and incomparable with the regulatory capital calculated under the proposed IMA rules.

- We believe that the QIS process would benefit from a review of the industry's concerns with regard to the current SA proposals, together with a dialogue on alternative proposals for the SA the industry is working on, which we believe will better achieve the objectives of the FRTB. This would then provide an opportunity to design a more appropriate QIS with relevant instructions to yield the best possible results for calibrating the SA.

- **Due to the material changes in the Internal Models Approach (IMA), there is insufficient time for implementation for the QIS, or to develop, in detail, necessary adjustments to address issues identified.**

  - As explained by the joint trade associations at the December 10th meeting, the liquidity horizon component of the IMA, as written, will create material implementation work. It will not be possible for most firms to build the processes to do that work for benchmark portfolios within the February-April timeframe. Additionally, most banks will have difficulty building the enhanced infrastructure required to implement the liquidity horizon component in time to do the proposed full trading portfolio QIS by the July-October timeframe.

  - In order to calculate an Expected Shortfall (ES) that factors in market liquidity as proposed, pricing grids/models would need to be recalibrated to work with a wider range of shocks, data infrastructure would need to be overhauled and data would need to be repopulated and revalidated to accommodate the use of overlapping long horizon returns. Furthermore, factor models and distributional assumptions would also need to be revised/re-estimated accordingly. The amount of time needed to implement all such changes will be very material.

- **The joint trade associations have been given a very short timeframe to formulate and submit robust counterproposals to key components of the IMA and the SA.**

  - The TBG requested that the industry submit its counter proposals by January 6th regarding the SA so that it can review them during its meeting in Singapore in late January. We note that this gave the industry less than a month to develop, formulate, analyze and evaluate all the consequences of its counterproposals. Within the imposed short time frame the industry was only able to submit to the TBG an outline of its counterproposals.

  - We hope the TBG will consider the merits of the outline of our counterproposals, and allow the industry more time to further develop them. We believe that given appropriate level of consideration and adequate time to develop these proposals, time and resources could be saved in the long run.

- **Finally, the industry offers its support to the TBG in designing and launching the QISs.**

    - We encourage the TBG to engage and coordinate with the industry in designing and launching the QISs. We believe industry insights can help further improve the design of the QIS in order to ensure the QIS is both efficient and provides the data that banks and the TBG require. In addition, improved coordination will ensure the quality of the output of the exercise, which is quite necessary to come up with robust calibration of the FRTB. We believe this will take time through an iterative process that adjusts the framework as we work through its design and calibration.

<u>Industry's proposal for revised timeline</u>

We have provided a proposed framework for determining a timeline for completing the FRTB that acknowledges the difficulties in achieving a robust and well-calibrated new framework for the trading book.

The reason we can only propose a framework at this point (as opposed to a specific timeline) is that the amount of time for each step, and the total number of steps needed to complete the FRTB are contingent on the detailed contents of the TBG's revised IMA and revised SA proposals. The detailed contents of each revision of the IMA and SA will affect the amount of time required by the industry to build new, or enhance existing calculations and data feeds.

We list two estimates of the minimum lead time required by a bank to build/enhance the components of its Risk IT infrastructure (i.e. calculation processes, data feeds, central aggregators and/or simulation engines) to run a full QIS on the bank's global trading positions, for each iteration of the IMA and/or SA proposal, contingent on whether or not enhancements need to be made to calculations and feeds from a bank's globally dispersed product processors:

- For each new proposed IMA or SA that requires enhancements to calculations and feeds from global product processors, banks typically will need a lead time of between six months to a year[4] to build/enhance, test, and validate:

    - The separate calculation processes on and data feeds from each product processor around the world required by the proposal (note different calculations and/or feeds may be required for the IMA and the SA)
    - The central risk aggregator required by each proposal (note separate aggregations will be needed for the IMA and the SA)
    - The simulations required by an IMA and/or the aggregation rules specified in an SA.

    The actual time will depend on the details of each proposal, as well as the size and global span of a bank's infrastructure. To provide some context, it is our estimate that it would take most banks at least one year to build the infrastructure required by the proposed SA, as currently written.

- If the proposed version of the IMA and SA does not entail enhancement to calculations and feeds from global product processors, and only requires enhancements to either a) the simulations required by an IMA, or b) the aggregation rules specified in an SA, then the lead time to enhance the infrastructure will be much shorter, typically around three to six months, depending on context.

[4] This will also depend on other regulator-driven and internal priorities; the estimates here assume that there are no other major regulatory initiatives being implemented at the same time.