30 September 2019

BY E-MAIL

Banking Policy Department
Hong Kong Monetary Authority
Two International Finance Centre,
8 Finance Street, Central,
Hong Kong

Dear Sirs,

Consultation paper on market risk (CP 19.01)

A. Introduction

The International Swaps and Derivatives Association, Inc. ("**ISDA**")[1] and the Asia Securities Industry & Financial Markets Association ("**ASIFMA**")[2] (together, the "**Associations**") are grateful for the opportunity to respond to the consultation paper on market risk (CP 19.01) ("**Consultation**") published by the Hong Kong Monetary Authority ("**HKMA**") on 28 June, 2019[3].

The Consultation proposes amendments to the Banking (Capital) Rules ("**BCR**") to revise the market risk capital charges for locally incorporated Authorised Institutions ("**AIs**") to align with the capital requirements for market risk[4] ("**FRTB**") published by the Basel Committee on Banking Supervision ("**BCBS**").

The Associations appreciate the work that HKMA is completing in this area, and for the opportunity to respond to the Consultation. We summarise our high-level response to the Consultation in *Section B, General comments and policy considerations*, and have provided detailed comments on the FRTB framework in *Section C, FRTB framework comments*.

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[1] Since 1985, ISDA has worked to make the global derivatives markets safer and more efficient. Today, ISDA has more than 900 member institutions from 71 countries. These members comprise a broad range of derivatives market participants, including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure, such as exchanges, intermediaries, clearing houses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's website: www.isda.org. Follow us on Twitter @ISDA.

[2] ASIFMA is an independent, regional trade association with over 100 member firms comprising a diverse range of leading financial institutions from both the buy and sell side, including banks, asset managers, law firms and market infrastructure service providers. Together, we harness the shared interests of the financial industry to promote the development of liquid, deep and broad capital markets in Asia. ASIFMA advocates stable, innovative, competitive and efficient Asian capital markets that are necessary to support the region's economic growth. We drive consensus, advocate solutions and effect change around key issues through the collective strength and clarity of one industry voice. Our many initiatives include consultations with regulators and exchanges, development of uniform industry standards, advocacy for enhanced markets through policy papers, and lowering the cost of doing business in the region. Through the GFMA alliance with SIFMA in the United States and AFME in Europe, ASIFMA also provides insights on global best practices and standards to benefit the region.

[3] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/consultations/CP19_01_Market_Risk.pdf, HKMA, Consultation paper on market risk (CP 19.01).

[4] https://www.bis.org/bcbs/publ/d457.pdf, BCBS, Minimum capital requirements for market risk.

We would like to highlight that as these discussions continue to evolve globally, the comments provided by the Associations in this response to the Consultation should not be considered as final. The Associations will continue to assess the final FRTB framework over the coming months, and evolve our positions as more data becomes available. We would also request that the HKMA provide the opportunity for further consultation and analysis once there is more clarity on global implementation of the final FRTB framework. As we have noted below, a key concern for our members is the timing of the overall implementation of the Basel III reform package. Piecemeal implementation of the Basel III reform package would be disruptive, burdensome, and inefficient.

With specific regards to market risk, it is important that the standards are implemented simultaneously and harmoniously across the key jurisdictions globally to avoid significant undue technological and business burdens for banks. Trading businesses of banks are fundamentally global, and fragmentation of trading books through inconsistent implementation would result in reduced capacity and frictions in the markets. We have discussed these concerns in more detail in *Section B, General comments and policy considerations*.

We would also like to call HKMA's attention to ongoing developments, both at the industry-level and BCBS, where a global FAQ process is underway to address interpretation ambiguities or potential rule "deficiencies" stemming from the final FRTB requirements published in January 2019. This FAQ process, led by ISDA, coordinates across global and regional banks to consolidate feedback on where BCBS text needs to be further clarified. This feedback was shared with the market risk group ("**MRG**") at BCBS at the end of June 2019.

Over the past few months, the FAQ process has focused on areas that warrant further discussion at BCBS, covering equity investment in funds (in the context of trading/banking book boundary and standard rules vs. internal models capitalisation), further clarification of the risk factor eligibility test, and interpretation issues on the standard rules.

Given the clarifications required, we would urge HKMA to consider further consultation on the FRTB framework now that the list of industry FAQs have been shared with the MRG and BCBS.

The Associations hope to continue the constructive dialogue between HKMA and market participants to assist HKMA in developing and finalising the FRTB framework. We note that our members may have feedback which they may wish to provide separately to HKMA.

B. General comments and policy considerations

The Associations consider it important that the final FRTB standards are implemented in a way that drives a robust and effective banking sector, whilst supporting the growth and development of the real economy in Hong Kong and the Asia Pacific region more broadly. In doing so, we urge the HKMA to assess the proposals in the Consultation against the overarching BCBS commitment to not significantly increase capital requirements, and ensure the HKMA carries out an impact analysis that goes beyond the aggregate analysis undertaken by the BCBS.

The Associations are broadly supportive of the approach outlined by HKMA, and of proposals which do not deviate from the BCBS standards in calibration and timeline. However, in finalising the Consultation proposals, we also request that the HKMA consider international developments in this area and monitor the adoption status in other key jurisdictions. Some areas that warrant further study are:

i. *Lack of international consistency and the risk of fragmentation*

The Associations consider it important that international standards such as FRTB are applied consistently across jurisdictions, enabling banks to operate on a global level-playing field whilst also reflecting the specific financial and economic circumstances of Hong Kong and the Asia Pacific region. Furthermore, it is important for globally active banks that international standards are implemented in a coordinated way, following a consistent timeline across jurisdictions, and with a reasonable implementation period for banks once the legislative process is finalised.

There is a chance that the HKMA implementation process will front-run the implementation process in other key jurisdictions such as the United States and European Union. The European Union has already indicated that implementation of FRTB under CRR II and CRD V will follow a two-step approach. The European Union approach will start with reporting requirements, moving subsequently to binding capital requirements which will form part of a separate legislative proposal which is expected to be published in June 2020, making it uncertain if the European Union will adhere to the BCBS timeline of January 2022 for FRTB capital binding requirements.

In addition, indications from the United States show that it is very likely that there will be a draft proposal FRTB published in late 2019 or early 2020. The Associations request that HKMA should continue to monitor the timeline for implementation in the European Union and United States, and not front-run implementation compared to these and other key jurisdictions. There is the real risk of regulatory fragmentation, and consequently implementation challenges for globally active banks, if the HKMA finalises the FRTB framework ahead of these key jurisdictions.

ISDA has discussed these fragmentation challenges, with a specific focus on FRTB, for Asia Pacific and emerging market economies in a report published in April 2019[5]. We request that the HKMA consider these concerns and monitor the adoption status in other key jurisdictions before finalising the Basel III and FRTB frameworks.

ii. *Clarity on other areas of the FRTB reforms expected to be reviewed by BCBS*

The Associations would like to highlight some areas of the FRTB standards that are expected to be reviewed by the BCBS and are not covered in the Consultation, but require further clarity from HKMA. We urge the HKMA to consult the industry in these areas in due course, and hope our comments provided in advance will assist the HKMA in formulating these policy proposals.

*a. Credit Valuation Adjustment ("**CVA**")*

The revised CVA capital framework was finalised as part of the overall Basel III reforms in December 2017[6]. However, next to the overall calibration of the CVA framework, a key area of concern is the limited recognition of hedges, which could be further amplified for banks in the Asia Pacific region by the difficulty of hedging exposure to less liquid counterparties. The calibration of the CVA framework will be informed by the revised FRTB framework, so it is possible that further refinements to the CVA framework may be needed, and we urge the HKMA to consult on such refinements.

[5] https://www.isda.org/a/eIeME/The-Fundamental-Review-of-the-Trading-Book-and-Emerging-Markets.pdf, ISDA, The Fundamental Review of the Trading Book and Emerging Markets.
[6] https://www.bis.org/basel_framework/index.htm?export=pdf&pdfid=15602572224168506, BCBS, The Basel Framework Consultative Document.

C. FRTB framework comments

i. *Deviations from the BCBS standards*

As we have highlighted in *Section B*, *General comments and policy considerations*, we are supportive of proposals which do not deviate from the BCBS standards, and the Associations appreciate the efforts of HKMA in broadly aligning the Consultation with the final FRTB framework.

However, there are a number of areas where the Consultation deviates from the final FRTB framework. A summary of such deviations is outlined in *Appendix A, Deviations from the BCBS standards*.

While the Associations understand and appreciate the need for supervisors to consider local specificities when implementing the FRTB framework, we would urge that further consideration is warranted in order to avoid any significant divergence from the final FRTB framework that may result in a lack of international consistency and market fragmentation.

The Associations request that the HKMA reconsider these divergences, and provide appropriate rationale for those deviations that address specific local market conditions.

ii. *Scope of entities*

The Associations would like to clarify the scope of entities to which the proposals in the Consultation will apply to. Paragraph 14 of the *Approaches to Calculation of Market Risk* section of the Consultation indicates that *"all locally incorporated AIs will be required to calculate the market risk capital charge in accordance with the new market risk standards"*[7]. However, paragraph 15 of the same section indicates that *"All AIs […] should calculate the capital charges using the Standardised Approach"*.

We request HKMA to clarify that only locally incorporated AIs are within scope of the market risk capital charge in accordance with the new market risk standards.

iii. *Standardised Approach ("**SA**")*

The revised SA published by the BCBS in January 2019 addresses many shortcomings of the earlier standard. The Associations strongly support the proposals to increase the risk sensitivity of the SA, however we believe that further changes are necessary to avoid further reduction in bank market-making capacity, along with ensuring that the SA remains a credible fallback to the internal model approach. The Associations would strongly support further review at the BCBS level in support of consistent implementation across jurisdictions.

a. *Equity risk weights*

At the risk class level, the industry notes the over conservative treatment within the SA. In particular, equity risk weights have not been reduced in the final FRTB framework, proposals for which were included in the March 2018 BCBS consultation paper[8].

[7] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/consultations/CP19_01_Market_Risk.pdf, HKMA, Consultation paper on market risk (CP 19.01), page 8.
[8] https://www.bis.org/bcbs/publ/d436.pdf, BCBS, Revisions to the minimum capital requirements for market risk.

b. Equity investment in funds

The impact of the FRTB standards, and more specifically the SA rules, is negatively affected by the final changes to the treatment of equity investment in funds. Given the possible interpretation of the latest standards that such funds are eligible for inclusion in IMA only if they are decomposed on a daily basis (where there is also concern that such an approach has significant operational complexities associated with implementation), some banks may have included these positions in SA. Since the SA treatment for equity investments in funds is very punitive (especially when they cannot be fully or partially decomposed), this will contribute to a higher overall FRTB capital impact.

*c. Residual risk add-on ("**RRAO**")*

The Associations would also like to highlight that the RRAO continues to be a concern, and note that the lack of risk sensitivity penalises well-hedged portfolios and leads to double counting of capital charges. Volatility and variance swaps are subject to the maximum 1% RRAO, even though their risk can be mostly hedged via vanilla options. In addition, the RRAO on yield curve spread options can make it uneconomical for banks to continue offering this product to clients such as pension funds, life insurance companies, corporates, and asset managers etc.

*d. Correlation trading portfolio ("**CTP**")*

The continuing ambiguity around the rules for CTP treatment and the requirement for index and index-tranches to be capitalised based on a non-look through approach continues to be a concern. Banks with exposure to such products have further noted the excessive impact arising from CTP products.

*iv. Internal Model Approach ("**IMA**")*

The Associations appreciate the revisions to the IMA published by the BCBS in January 2019. However, the IMA capital requirements are still punitive compared to the expectations from an overall capital increase perspective, and may have a negative effect on incentives for banks to pursue the IMA for market risk.

a. Lack of diversification

One key driver of the impact under IMA is the loss of diversification inherent in the different parts of the framework. Examples of this include bifurcation of the firm-wide portfolio into IMA and SA sets, where there is no diversification between delta/vega/curvature within SA, limited diversification within SA default risk charge ("**SA DRC**"), and across asset classes in expected shortfall ("**ES**") and across NMRFs etc.

The Associations would like to highlight that the levers currently embedded in the standards of IMCC Rho and NMRF Rho parameters can be leveraged either individually or in combinations, and have a direct impact on the IMA capital.

*b. Non-modellable risk factors ("**NMRF**")*

The Associations appreciate all the significant changes made across the IMA, focused on NMRF. However, this remains a concern and source of uncertainty in the FRTB framework as NMRFs could account for a disproportionate amount of the market risk capital requirements. This could result in overcapitalisation and poor alignment with the underlying risks, and will have a negative effect on incentives for banks to develop internal models for market risk.

c. *Profit and loss attribution ("**PLA**")*

The Associations welcome the revisions to the PLA test and significant enhancements to the framework, including more appropriate treatment of data alignment, improved test frequency requirements, revised test metrics and an enhanced penalty function.

It is crucial that the determination of appropriate thresholds for PLA is based on tests using real portfolios. Therefore, the industry strongly recommends that HKMA review the thresholds once banks are able to develop the system capabilities to produce reliable data for both the risk theoretical and hypothetical profit & loss.

As a final note, we encourage HKMA to take the changes that result from the final analysis back to the BCBS, and obtain the necessary revisions to the relevant BCBS standards. Changes at the Basel level are necessary to facilitate consistent implementation on a global basis.

The Associations thank HKMA for considering our comments. We look forward to continued dialogue on these issues going forward, and we remain at your disposal in the development of the final Basel III and FRTB frameworks. We also welcome the opportunity to meet with HKMA to further discuss any of the issues raised above in more detail. Should you have any questions, please do not hesitate to contact Rahul Advani at ISDA (radvani@isda.org or at +65 6653 4170) or Matthew Chan at ASIFMA (mchan@asifma.org or at +852 2531 6560).

Yours sincerely,

For the **International Swaps and Derivatives Association, Inc.** and **Asia Securities Industry & Financial Markets Association**

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APPENDIX A
Deviations from the BCBS standards

No.	Area	HKMA proposal	Reference in HKMA consultation[9]	BCBS final standard	Reference in BCBS final text[10]
A. Standardised Approach (SA)					
1.	**Equity Risk**	The determination of market capitalisation should be updated in a regular interval, at least on a weekly basis, and at the end of every month.	Paragraph 165	No such requirement.	N/A
2.	**Foreign Exchange Risk**	The risk weight of USD/HKD may, at the discretion of the AI, be set at 1.3% on the rationale that this risk weight captures the fluctuation of USD/HKD within the Convertibility Undertaking range (i.e. 7.75 to 7.85) under the Linked Exchange Rate System.	Paragraph 181	No such requirement.	N/A
B. Internal Model Approach (IMA)					
3.	**Stress Testing**	An AI should provide the HKMA with information on its **five largest daily losses** experienced at the firm-wide and trading desk level respectively during each calendar quarter.	Paragraph 292	A bank should have information on the **largest losses experienced during the reporting period** and may be required to make this available for supervisory review.	Paragraph 30.23 (1)
4.	**Specification of Risk Factors - Equity Risk**	An AI should incorporate risk factors corresponding to each of the equity markets in which the **AI holds positions**.	Paragraph 307	For equity risk, a bank must utilise risk factors that correspond to each of the equity markets in which the **bank holds significant positions**.	Paragraph 31.9

[9] https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/consultations/CP19_01_Market_Risk.pdf, HKMA, Consultation paper on market risk (CP 19.01).
[10] https://www.bis.org/bcbs/publ/d457.pdf, BCBS, Minimum capital requirements for market risk.

5.	**Third-party vendor data**	The vendor is subject to an external audit regarding the validity of its pricing information **on at least an annual basis**.	Paragraph 320	The vendor is subject to an audit regarding the validity of its pricing information.	Paragraph 31.14 (3)
6.	**Backtesting & PLAT**	For an AI to remain eligible to use the IMA, **a minimum of 30%** of its aggregate market risk capital charges should be based on positions held in trading desks that qualify for the use of internal models by satisfying the backtesting and PLAT as set out in this subsection. This **30% criterion** should be assessed by the AI on a quarterly basis when calculating the aggregate capital charges for market risk according to subsection 25.	Paragraph 341	For a bank to remain eligible to use the IMA to determine market risk capital requirements, **a minimum of 10%** of the bank's aggregated market risk capital requirement must be based on positions held in trading desks that qualify for use of the bank's internal models for market risk capital requirements by satisfying the backtesting and PLA test as set out in this chapter. This **10% criterion** must be assessed by the bank on a quarterly basis when calculating the aggregate capital requirement for market risk according to [MAR33.43].	Paragraph 32.2