

POSITION PAPER



ESBG response to the EBA consultation on the new Internal Model Approach (IMA) under the Fundamental Review of the Trading Book (FRTB)

ESBG (European Savings and Retail Banking Group)

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Dear Sir/Madam,

Thank you for the opportunity to comment on the EBA consultation on the new Internal Model Approach (IMA) under the Fundamental Review of the Trading Book (FRTB). We welcome the proposals made. At some points we feel that the proposals are far more normative than the Basel text. This could lead to unnecessarily rigid rules. The discretion of supervisors would be too limited. Against this background, we would like to share with you the following reflections that we hope will be considered by the EBA.

Consultation 1: Draft Regulatory Technical Standards on Liquidity horizons for the Internal Model Approach

Question 1: Do you agree with the general methodology? If not, please explain why.

We have no objection.

Question 2: Besides systemic risk factors (i.e. risk factors capturing the market/systemic component of the modelled risk), are there other risk factors/parameters that would reflect risks embedded in more than one subcategory or more than one categories?

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Question 3: Do you agree with the treatment reserved for homogenous indices?

We have no objection.

Question 4: Do you have any example of other risk factors that should be subject to the treatment specified for indices?

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Question 5: Are there any other risk factors for which an ad-hoc treatment should be specified?

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Question 6: What is your preferred option? Please explain why.

We prefer Option B. The inclusion of equities according to Regulation 2016/164610 allows for better reflection of EU capital markets specifics.

Consultation 2: Draft Regulatory Technical Standards on Criteria for assessing the modellability of risk factors under the Internal Model Approach (IMA) under Article 325be(3) of Regulation (EU) No 575/2013 (Capital Requirements Regulation 2 - CRR2)

In general, EGB agrees to the argument brought forward by ISDA/IFF that a further narrowing definition of “legally obliged” would reduce liquidity and usage of quotes for main instruments. Furthermore, we think that the requirements for the RFET should be set in a way that they can be fulfilled not only for the most liquid risk factors. Especially for volatility surfaces a proof of the modellability based on the



current proposal would be simple not possible or in the best case very time consuming and/or expensive dependent on the availability of the data providers. In the current proposal the requirements are set independent of the significance of the overall position in a certain risk factor. ESBG sees these strict requirements as an entry barrier for the implementation of an Internal Model, especially for smaller and medium size institutions.

Question 1: Do you agree that a committed quote, to be considered verifiable, should be required to have both a firm bid and offer price? If you think that solely a bid or offer price should be sufficient please provide a convincing rationale.

ESBG thinks that for certain markets/instruments one firm side could be sufficient e.g. available firm bids for corporate bonds would prove existing market liquidity – which is the overall purpose of RFET.

Question 2: Please provide an estimation of the impact of requiring solely a firm bid or offer price compared to requiring both. Please provide this impact e.g. in terms of number of non-modellable risk factors, stress scenario risk measure charge or number of eligible committed quotes for different risk factors/ risk factor categories.

Some of our members have not contracted specific vendor service we cannot provide an answer. No impact analysis was done so far in those cases.

Question 3: How would you define and check for a “non-negligible volume of a transaction or quote, as compared to usual transaction sizes for the bank, reflective of normal market conditions” for the purpose of assessing the validity of a price observation?

All 3 restrictions (Intragroup, Volume, Bid/Ask) are overly (and unnecessarily) complex in our view. It should be possible to use all quotes provided that banks show that the quotes reflect normal market conditions.

Question 4: How would you define and check for an “unreasonably large bid-offer spread as compared to usual bid-offer spreads, reflective of normal market conditions” for the purpose of assessing the validity of a price observation obtained from a committed quote? In your response, please provide a detailed reasoning.

All 3 restrictions (Intragroup, Volume, Bid/Ask) are overly (and unnecessarily) complex in our view. It should be possible to use all quotes provided that banks show that the quotes reflect normal market conditions.

Question 5: Do you see any problems with requiring that institutions are allowed to use data from external data providers as input to the modellability assessment only where the external data providers are regularly subject to an independent audit (independent of whether the price is shared with the institution or not)? If so, please describe them thoroughly (i.e. for which data providers and the reasons for it).

Yes, potentially. The question must therefore also be discussed with the data providers. Since it can be assumed that a significant amount of information would be required of them, it must be ensured that the requirements can be fulfilled with reasonable efforts by them. Otherwise the information needed for the model would not be available or be very expensive.

Question 6: Do you have any proposals on additional specifications that could be included in the legal text in order to ensure that verifiable prices provided by third-party vendors meet the requirements of this Regulation?



We have no additional proposals.

Question 7: How relevant are the provisions outlined above for your institution? How many and which curves, surfaces or cubes are (planned to be) represented by a mathematical function with function parameters chosen as risk factors in your (future) internal model?

This topic is of high relevance. Some of our members use parametric functions for all important volatility surfaces (Interest rates, Equity and FX volatilities) as e.g. SABR model, SVI model. However, although pricing is based on the parametric representation, these parameters are not risk factors. The risk factors are still the volatility quotations themselves (which are shifted in each scenario and afterwards new SABR parameters are derived in the scenario calculation).

Question 8: Do you have a preference for any of the options outlined above? For which reasons? Please motivate your response

We do not have a strong preference for either. In fact, we share the opinion of ISDA/IIF that both options have significant practical limitations.

Question 9: Do you consider any of the options outlined above as impossible or impractical? For which reasons? Please motivate your response

If option 1 requires a historic recalibration it would not be possible from an operation point of view. Option 2 can be based on all input factors – including non-modellable – a parametric model is to deliver calibration parameters as well as output risk factors. On this output level the exclusion of risk factors from non modellable buckets would take place. In cases where pricing functions are setup on model parameters it would require to establish new pricing functions (e.g. SVI). In cases where the pricing functions is setup to use the output risk factors we see open questions with respect to use of a non modellable basis in contrast to a full exclusion of the bucket.

Question 10: Do you have alternative proposals to define the consequence on the modellability of the parameters where some buckets of a curve, surface or cube are modellable whilst others are non-modellable?

We support the ISDA/IIF proposal.

Q11: Do you intend to apply paragraph 4? If so, for which risk factors will it be relevant? Do you expect any implementation issues related to it? Please explain expected issues thoroughly.

Some of our members intend to rely on the services of data providers to be established and avoid building up own tracking routines of original maturities vs. actual maturities. Notwithstanding, these are in favor of any possibility which helps to improve the diminishing demand for bonds with remaining short term maturities 0-1,5years (which were often highly liquid when issued at e.g. 5Y original maturity).

Question 12: Do you agree with the outlined methodology for the assessment of modellability of risk factors? If not, please explain why

Since some of our members will not have sufficient own trades, they will need to rely on data service provider.

Question 13: Do you expect any problems for the modellability assessment arising from the upcoming benchmark rate transition that could be addressed via this regulation? If so, please provide a thorough description and potential solutions if any.



As soon as a liquid markets new reference rate is established, we do not expect additional problems. The important question is to ensure recognition of equivalence of the new benchmark: the industry is in favor of a legal act to ease the transition with clients.

Question 14: How do you intend to integrate the risk factor modellability assessment (i.e. RFET) into the processes of your institution? Do you expect those data to be used for the purpose of the RFET only or do you think those data would increase the data availability used e.g. for the calibration of your internal model (under para 31.26 of 2019 Basel rules)? What percentage of data used for the RFET do you think will be used also for the calibration of your internal model?

We believe that the RFET is primarily a stand-alone test. Daily marked-to-market prices are available shortly following the close of trading. Vendor service data will most likely not be available during this time but only later with a considerable time delay.

[Consultation 3: Draft Regulatory Technical Standards on Criteria for assessing the Draft Regulatory Technical Standards on Back-testing requirements under Article 325bf\(9\) and Profit and Loss attribution requirements under Article 325bg\(4\) of Regulation \(EU\) No 575/2013 \(Capital Requirements Regulation 2 - CRR2\)](#)

Question 1: Which are the adjustments that institutions include in the fair value of a financial instrument that you consider not sensitive to market risk? Please provide a list of adjustments or a list of types of adjustments.

Credit Value adjustments: we do not see relevant for the market risk charge since it is covered by a separate CVA charge. Bid/Ask adjustment is sensitive to the market liquidity of the instrument, but this risk is covered by the Prudent Valuation adjustment which is deducted from CET1.

Question 2: Which are the adjustments that institutions include in the fair value of a financial instrument that you consider market risk sensitive? Please provide a list of adjustments or a list of types of adjustments.

We do not see any additional adjustments in the fair value of a financial instrument which we consider as market risk sensitive.

Question 3: Paragraph 4 specifies that no smoothing of adjustments is permitted over the readjustment period. Do you agree with the provision? Do you consider the provision clear?

We support the ISDA/IIF proposal.

Question 4: Paragraph 4 requires institutions to compute (for the purpose of the backtesting) the value of an adjustment (that is included in the changes in the portfolio's value) performing a stand-alone calculation, i.e. considering only the positions in the trading desk. Do you agree with the provision? Do you consider the provision clear?

We support the ISDA/IIF proposal.

Question 5: Do you agree with the criteria in paragraph 5 allowing institutions to exclude an adjustment from the changes in the trading desk's portfolio value? Are there any other criteria you deem useful for this purpose?



We support the ISDA/IIF proposal.

Question 6: How do institutions identify client margins and day-one profits/losses in the systems (e.g. as commissions, margins)? Please specify if currently they are taken into account in the end of- day valuation process, in the actual P&L and in the hypothetical P&L.

Based on the survey which was published by ISDA/IIF there is already some kind of market standard how margins and day-one profits/losses are taken into account in the end-of-day valuation process, in the actual P&L and in the hypothetical P&L.

Question 7: Paragraph 4 requires institutions to compute (for the purpose of the backtesting) the value of an adjustment (that is included in the changes in the portfolio's value) performing a stand-alone calculation, i.e. considering only the positions in trading desks that are calculating the own funds requirements using the internal model approach (i.e. desks meeting all conditions in article 325az(2)). Do you agree with the provision? Do you consider the provision clear?

We support the ISDA/IIF proposal.

Question 8: Do you agree with the possibility outlined in paragraph 5 to include in the portfolio's changes the value of an adjustment stemming from the entire portfolio of positions subject to own funds requirements (i.e. both positions in standard-approach desks and positions in internal model approach desks)? Or do you think it would not be overly burdensome for institutions to compute adjustments on the positions in trading desks that are calculating the own funds requirements using the internal model approach only?

We support the ISDA/IIF proposal.

Question 9: Do you agree with the criteria outlined in this article for the alignment of input data? Please provide some examples where an institution could use the provision set out in paragraph 2.

We support the ISDA/IIF proposal.



About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 20 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 1,000 banks, which together employ 780,000 people driven to innovate at 56,000 outlets. ESBG members have total assets of €6.2 trillion, provide €500 billion in SME loans, and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking.



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