

Industry FRTB QIS Analysis

The International Swaps and Derivatives Association (ISDA), the Global Financial Markets Association (GFMA) and the International Institute of Finance (IIF) set out in this document their key findings from the analysis of the results that 28 banks¹ submitted to the Basel Committee on Banking Supervision's (BCBS) Quantitative Impact Study (QIS) on the Fundamental Review of the Trading Book (FRTB) with June 2015 reference data (henceforth "QIS analysis"). The objective of this initiative was to investigate the aggregate impact of the proposed FRTB framework and to provide data-driven feedback to the policy-makers for further consideration.

The Basel QIS submissions for the 28 globally / locally significant banks were combined to generate comparative metrics for an "Aggregate Bank". The quantitative analysis was complemented by qualitative reviews, including a survey of banks' confidence in their interpretation of the QIS instructions and of the estimates that they submitted. We believe this supplementary qualitative information provides useful context for the estimates of an industry-wide impact of the current FRTB proposals.

We are encouraged by and commend the Trading Book Group's (TBG) efforts to find solutions to the issues that have been identified to date, and remain committed to assisting in the resolution of the remaining outstanding issues. Overall, the analysis, conducted by the Global Association of Risk Professionals (GARP), reveals the importance of addressing the remaining technical issues before the rules are finalised by year-end. The QIS analysis results referenced in this report are based on our member banks' submissions to the BCBS on October 7th 2015.

We believe that changes are required to certain framework components to ensure a balanced and more robust market risk framework that achieves the objectives set for the FRTB. While some specific product areas and markets appear to be penalised in a more granular analysis, our "top of the house" analysis identified the following broad areas in the framework² that are unlikely to be addressed via a recalibration after the FRTB is completed:

- Residual risk add-on;
- Securitisations;
- Non-modellable risk factors (NMRFs); and
- P&L attribution.

In particular, we would like to highlight that while the replacement of the correlation asymmetry in the Standardised Approach (SA) methodology – a measure that was shown by previous QISs to result in punitive and uneconomic capital results – the introduction of the residual risk add-on in the SA framework significantly offsets this improvement. The add-on itself now accounts for **47%** of the total market risk capital for the revised SA.

¹ Bank of America, Barclays, BNP Paribas, CIBC, Citi, Commerzbank, Credit Agricole, Credit Suisse, DBS, Deutsche Bank, Goldman Sachs, HSBC, ICBC Standard Bank, ING, Intesa San Paolo, JPMorgan Chase, Morgan Stanley, NAB, Nomura, Nordea, Royal Bank of Canada, Royal Bank of Scotland, Scotia Bank, SEB, Societe Generale, UBS, Unicredit, and Westpac.

² Our analysis currently excludes the proposals for and QIS on the revised Credit Valuation Adjustment ("CVA")

Standardised Approach (SA)

- **4x Current Market risk Capital:** The capital charge of the SA methodology is **4.2 times** the total market risk capital that firms hold today. This level is too high, if the policy objective remains to have the SA as an alternative to modeled capital. Furthermore, the proposed standardised floors rules may further exacerbate changes in bank trading behaviours and market liquidity fragmentation that result from the non-risk-sensitive components of the framework.
- **Driven by the Residual Risk Add-on (RRA):** A significant component of the SA capital charge relates to the RRA that was introduced into the framework via the June 2015 QIS instructions. The residual risk add-on accounts for **47%** of the total market risk capital for the SA.
 - **Proposal:** A notional-based add-on should not be part of the framework because it is not risk sensitive. It acts more like a tax on volume, and threatens the key objective of a credible fallback to internal models. In addition, the scope of products is too wide as it includes products that are conservatively calibrated elsewhere in the SA.
- **Cliff effect due to large difference compared to the IMA:** There is still a large gap evidenced in the QIS results between the revised SA and the IMA, which may give rise to cliff effects in the event a trading desk loses internal model approval. According to our analysis, the capital increase could increase between 2.1 and 4.6 times depending on the risk factor class, which means disproportional impact across different asset classes as illustrated in the table below:

| | SA to Expected Shortfall * |
|-----------------------|----------------------------|
| Interest rate risk | 4.2 |
| Credit spread risk | 2.1 |
| Equity risk | 4.6 |
| Commodity risk | 3.6 |
| Foreign exchange risk | 3.8 |

*SA excluding RRA & IMA excluding NMRF

- As part of the calibration of the framework it is critical that differences across assets classes are harmonized to better reflect the economic risk and align to the FRTB objectives (e.g. SA should not be twice as punitive for Equities vs Credit). This is important in the context of mandatory desk level external disclosures, as well as desk viability.
- **Securitisation impacted adversely:** Despite changes to previous draft rules, securitisations are still impacted negatively. The results show a **2.2 times** increase in capital from Basel 2.5. This runs counter to other regulatory objectives of restoring confidence in the securitisation market, as a source of funding and growth; instead the FRTB framework will likely lead to a contraction of the securitisation market.
 - **Proposal:** Industry has suggested an alternative specification that removes the credit spread risk charge, which overlaps with the banking book charge. This alternative is based on the banking book framework and addresses the double count issue, and would not require material BCBS resources and testing for completion. Furthermore, the industry proposal would increase comparability and transparency of the overall capital framework.

Internal Models Approach (IMA)

- **Large NMRF Contribution:** NMRFs account for **29%** of the total proposed market risk capital charge, **4.3 times** the risk not in VaR (RNIV) capital charge (based on subset of banks that calculate RNIV in the current framework) and **1.5 times** the expected shortfall (ES) risk measure.
- The real price criteria implications are not fully explored across all asset classes and might lead to a systemic ineligibility of risk factors and a significant deterioration in Market Risk model performance across the industry.
 - **Proposals:** Industry recommends a multifaceted approach: a) Allow zero correlation assumption for the aggregation of the NMRF b) revise the real price criteria to include internal marks that are being used for P&L subjected to firms' internal price verification (IPV) processes, and c) consider inclusion of the idiosyncratic risk component in the ES model as permitted under the current regime.
- The estimated impact of the revised DRC compared to the current IRC (**2.3 times**) needs to be properly calibrated with respect to the key regulatory prescribed parameters in light of the results such as the 3bps PD floor and others³.
- **P&L Attribution Test challenging to implement:** Based on a survey conducted across the participating banks in the industry QIS analysis only a limited number of banks have been able to contribute data for the P&L Attribution test. Therefore, calibration of the P&L Attribution thresholds would not be based on representative sample of banks' data
 - **Proposal:** Allow sufficient time for banks and regulators to develop the required infrastructure in order to test, refine and properly calibrate the P&L attribution criteria. This can be done as part of the implementation process and, therefore, the final FRTB policy framework should avoid constraining this iterative process.

Overall, although significant progress has been made in addressing the issues in the proposed FRTB framework, there are still major components of the framework that need to be addressed in order to ensure that the FRTB rules do not increase the trading book capital requirements, an objective previously communicated by the BCBS.

³ size of the LHs and the 50% reduction in diversification