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Submitted via email: baselcommittee@bis.org

Wayne Byres
Secretary General
Basel Committee on Banking Supervision
Bank of International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Definition of capital: Maturity restrictions for short positions in the trading book

Dear Mr Byres

The Global Financial Markets Association\(^1\) wishes to draw to the Committee’s attention a serious issue concerning the recognition of short positions in the calculation of capital deductions required for investments in unconsolidated financial institutions, as required under Basel III\(^2\). We believe that the current Basel III wording will unintentionally restrict banks’ ability to provide liquidity and carry out market making activities, and therefore ask the Committee to reconsider the requirement.

The issue relates to the maturity restriction applied to short positions to determine the ‘net long position’ in an underlying exposure, and the implication of this for trading

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\(^1\) GFMA joins together some of the world’s largest financial trade associations to develop strategies for global policy issues in the financial markets, and promote coordinated advocacy efforts. The member trade associations count the world’s largest financial markets participants as their members. GFMA currently has three members: the Association for Financial Markets in Europe (“AFME”), the Asia Securities Industry & Financial Markets Association (“ASIFMA”), and, in North America, the Securities Industry and Financial Markets Association (“SIFMA”).

\(^2\) [http://www.bis.org/publ/bcbs189.pdf](http://www.bis.org/publ/bcbs189.pdf).
book exposures\(^3\). The US Final Rules and EU Capital Requirements Regulation (CRR), implementing paragraphs 80 and 84 of Basel III, require banks to deduct from regulatory capital their ‘investments’ in the capital instruments of financial institutions that are outside the scope of consolidation.

The deduction is based on the net long position, which is derived by calculating the value of the gross long position less the value of the gross short position in the same underlying exposure. For indirect or synthetic holdings, including index positions\(^4\), this requires looking through the instrument to the underlying exposure and identifying the specific instrument(s) referenced and its value.

Critically, only short positions which match the maturity of a long position or have a residual maturity of at least one year are eligible to be included in the population of short positions.

The BCBS Definition of Capital FAQs published December 2011\(^5\) clarified that short positions in the trading book can be recognised as eligible for netting in specific instances (short positions in decomposed indices and contractual obligations for a counterparty to receive cash equities) as the maturities can be determined to be matching.

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\(^3\) Note that the industry, in response to the Basel Committee’s consultation on the Basel III framework, advocated that trading book positions be exempted from this capital deduction. Our recommendation was not accepted, and it is increasingly clear that the one-year hedge restriction will have significant unintended consequences.

\(^4\) While we recognize the need to include long positions arising from a position in a financial sector index, we do not believe that positions in financial institutions that arise from holdings in “broad-based” indices should be included, since they do not give rise to the same concerns on double-counting of regulatory capital in the system nor wider interconnectedness to financial institutions (i.e., a bank would not hold a position through a broad-based index instead of holding a particular financial institution stock). Exempting long positions in broad-based indices from the scope of the deduction could be achieved through referencing the existing definition of “broad-based index” as used in the Committee’s Market Risk Requirements.

\(^5\) [http://www.bis.org/publ/bcbs211.pdf](http://www.bis.org/publ/bcbs211.pdf). Specifically, see page 13 of the document.
GFMA appreciates the relevance of the residual and matching maturity criteria for banking book investments in unconsolidated financial institutions, since these are generally longer-term investments of a bank. Requiring a short position to be of at least one year residual maturity is consistent with the framework’s design to capitalise banking book risks to a one-year horizon.

However, we believe that the requirement for short positions to have a residual maturity either matching that of the long position or of more than one year is inappropriate for trading book positions for the following reasons (each of which is explained in detail in Annex 1):

- The requirement creates severe practical difficulties for trading book management
- The rule conflicts with the existing trading book capital treatment
- The rule is inconsistent with prudent risk-management activities
- The rule is inappropriate for long hedge positions
- The rule does not consider ‘economic’ delivery of positions
- The maturity restriction does not recognise the significant liquidity of many trading book positions

All banks that facilitate clients’ investment in financials or carry out market making in financials will be affected by the rule, and particularly so for those banks that carry out such activities as a core part of their business model. We believe that the combined effect of the issues outlined above will lead to higher hedging costs and reduced market liquidity in financial institution stock, forcing banks to make a decision between:

1. accepting higher basis risk (such as funding basis risk and greater levels of real maturity mismatch from extending hedges to over one year to hedge short-term positions) and costs through entering into more complex, expensive and bespoke hedging strategies, and/or
2. deciding only to facilitate long-dated positions with clients, or
3. deducting the position from capital resulting in higher costs for the client.

Each approach will make it more difficult or expensive for investors to enter and exit positions, not only lowering their returns but also likely diminishing their appetite for financial institution equities altogether, given lower market liquidity. This is even the case if they are seeking broad exposure to the sector through an index. These rules could therefore undermine at the margins regulators’ desire to increase capital in the banking sector as Basel III becomes effective.

Given the fundamental difference between banking book ‘investments’ and trading book ‘positions’, it is critical that – to avoid serious consequences for market liquidity in financial institution stock – an alternative approach be allowed for trading book positions.

GFMA asks the Committee to consider the policy approach it has taken with regard to this requirement and whether the outcomes described above were contemplated when developing the rules. Specifically, GFMA asks that maturity restrictions are removed for short positions in the trading book in line with the conditions stipulated by the Committee for short index positions, where the firm can demonstrate that the hedge is effective under the bank’s internal control processes assessed by supervisors. We provide in Annex 2 proposed amendments to align existing FAQs with this position.

We would welcome any opportunity to discuss further these proposed, or alternative, amendments with you.

Yours sincerely

Simon Lewis
Chief Executive, GFMA
Annex 1: Reasons supporting a change of approach

The requirement creates severe practical difficulties for trading book management

The purpose of market-making portfolios is to facilitate client demand, and these portfolios are generally composed of numerous positions, the risks of which are hedged in different markets. While the rules provide for hedge recognition where the hedge has a ‘matching’ maturity with the long position, this will often not be the case – if a client seeks access to a particular index or name for 30 days, it may not be possible or will be prohibitively expensive for the bank and therefore its client, to hedge that exactly for 30 days. The hedge is likely to be done in the liquid, listed futures and options markets which have standard quarterly dates, so the hedge may not be for the same 30 days. In addition, futures and options markets’ quarterly roll dates are also often on different days of the week, so there may be a small one-day exposure on hedges between those markets – but this one-day mismatch could give rise to a full deduction if daily matching is required under the rules as written.

It is simplistic to presume that trades are paired, with one long trade offsetting one short trade. Rather, banks hedge the risks arising from their client and market-making trades – some long client trades may hedge some short client trades, in whole or in part, and the aggregate resulting long or short position arising from client trades may be hedged by one or several hedging instruments. Variances in the basis of positions are captured in market risk requirements. Requiring trades to be “paired” in this way will be contrary to the way positions are currently hedged, and will create

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6 The example cited also raises a further industry concern that positions arising via broad-based equity indices such as the S&P500 or EuroStoxx 50 are inappropriately included by virtue of the indirect and/or synthetic exposure look-through requirements. Such indices cannot realistically be used to take strategic investments in financial sector entities and thus pose little of the Committee’s concerns on interconnectedness. We urge that long positions in such broad-based indices (as already defined in the Committee’s market risk capital rules) should therefore be explicitly excluded from the deduction requirements.
unnecessary trade volume and basis risk (see also the paragraph below with header “The rule is inconsistent with prudent risk-management activities”).

The rule conflicts with existing trading book capital treatment

While the maturity restriction is not a new restriction for the banking book, it is for the trading book. Under current Basel 2 banking book equity capital requirements, investments can only obtain capital relief if the hedge instruments have maturity of at least one year\(^7\). However the restriction is new to trading books where current market risk rules require calculation of risk-weighted assets for equity positions in the trading book to be netted against one which is achieved by using the “delta” of the financial instrument (e.g. long cash equity vs 3-month short equity option is netted under Paragraphs 718(xxii) and 718(Lvii)). Delta calculations, determined in accordance with the Market Risk Requirements, provide the most accurate, risk-sensitive approach for calculating trading book equity exposures\(^8\). The new restriction creates an undesirable internal conflict within the Basel Framework for trading book positions but not for banking book positions. In addition it will lead to inconsistent risk management behaviour between financial and non-financial equity markets.

Moreover, because the Market Risk Requirements dictate that positions and/or associated hedges may only be eligible for the trading book if they are held with short-term trading intent (which is typically less than one year), it seems contradictory to require a one-year minimum hedge maturity for these positions under the financial institution deduction. We also note that the Basel Committee has previously acknowledged that a different treatment for trading book positions in

\(\begin{align*}
7 \text{ Para 345 of Basel 2} \\
8 \text{ Banks manage exposures as a function of delta, which measures the relationship of a change in the instrument’s value with changes in an underlying factor (such as a stock price). For example, consider a deeply out-of-the-money one-day call option with a spot price of 100 and a strike price of 120. The probability of hitting the strike price in one day is low, which will typically result in a delta of close to zero. However, the delta will gradually increase as the expiration date is extended, which reflects the higher probability of the price moving to 120. Moreover, deltas are used to calculate market risk capital and represent a well-understood risk-sensitive measure used to manage the risks of trading book exposures precisely because they take maturity into consideration.}
\end{align*}\)
financial institutions is appropriate, subject to the bank having in place adequate systems and controls as an active market maker (see existing paragraph 689(ii)). The status of this paragraph in the Basel III framework is unclear.

**The rule is inconsistent with prudent risk-management activities**

The rule penalises banks that prudently manage their risks and could have unintended consequences. For example, if a client wishes to short a financial institution for five days through an equity swap, the market-making bank on the other side of the transaction will need to hedge this synthetic long by going short, for example via a futures contract at the next quarterly roll date. In accordance with the rules, it would be more capital efficient for the bank to enter into a hedge that has a maturity of one-year or more, rather than hedging in the most liquid short-dated market, even though there is significantly more basis risk (and expense) in using the one-year hedge.

Furthermore, the bank is fully hedged for the duration of the long position but the rules would still consider the short position to be an ineligible hedge. The rules perversely encourage less effective hedges that “disconnect” the hedge from the true underlying risk, which will increase risk in the financial system rather than reduce it.

**The rule is inappropriate for long hedge positions**

The maturity netting restriction is inappropriate for market making activity where the short position is the risk-taking position and the long position is the hedge.

The rules are premised on the idea that the bank enters into a long risk-taking position, and then hedges with a short position. While this may be the case for a more strategic banking book ‘investment’, this assumption is inappropriate for market making that facilitates clients’ needs. For example, if a pension fund wishes to take a long position in the Eurostoxx 50 via a 3-month swap, the bank will take the opposite side representing a short, offsetting position in the Eurostoxx 50. The bank will hedge with a long market position. Such hedges are typically short-term in nature (since these are the most liquid markets), but as noted above, the standard dates in the
listed futures and options markets may not perfectly match the bespoke 3-month maturity of the risk-taking short position. It would be perverse to request to the client to increase the maturity to more than 1-year – beyond the client’s desired maturity – so as to satisfy regulatory requirements. The rule also creates an undesirable incentive for the bank to avoid the “long” hedge.

**The rule does not consider ‘economic’ delivery of positions**

Equally, in specific situations, a bank may face a client on a synthetic position (e.g. swap) in which the client establishes a long exposure to a capital instrument of another financial institution. Since the bank has a short position, it may choose to purchase the underlying capital instrument to hedge its exposure to the client. If the maturity of the synthetic position does not match that of the hedge, holding the capital instrument on its balance sheet may require the bank to make a deduction from capital, even though the banking institution’s exposure to the financial entity is entered into to hedge its exposure to its client. Deductions related to such client-facing activities could be very significant and volatile for banks that regularly enter into swaps or similar instruments with clients.

In the situation described above, a regulatory capital deduction is unwarranted because the bank’s market risk on the underlying equity instrument is fully hedged. Further, contractual arrangements ensure that clients, not banks, bear market risk associated with such positions. In addition, because banks can terminate the hedge (and the exposure to the capital instrument) at the same time as closing out the client’s synthetic position – the bank can thus eliminate the market risk associated with the client-facing position. Capital markets have demonstrated strong and reliable liquidity, even in times of market stress, thus ensuring that banks are able to sell equities in response to client requests to terminate equity-linked swaps in an orderly and non-disruptive manner, providing even more prudence beyond contractual protections and requirements to post daily margin.

The bank’s risk arises from its credit risk to its client, who is generally required to post significant initial margin to cover potential future falls in the value of the
underlying equity instruments, as well as post daily variation margin to cover ongoing changes in the value of such instruments. This risk is already addressed in credit risk capital requirements.

For example, equity-linked swap transactions play a large role in the overall market for equities, and implementing the deduction as proposed would have significant market effects. The typical counterparties for equity-linked swaps are not other banks, but rather asset managers and funds, which make extensive use of these swaps to gain exposure to financial institutions’ equity securities. Requiring banks to take a regulatory capital deduction for equities held as hedges on those equity-linked swaps would make many such transactions uneconomic for banks, thereby restricting access to equity exposures and causing disruptions to market activity. Because many asset managers primarily utilise equity-linked swaps to gain exposure to equities, the proposed deduction would materially weaken the liquidity of these instruments, which will itself negatively impact the ability of asset managers to invest and trade on behalf of their clients.

The maturity restriction does not recognise the significant liquidity of many trading book positions

The rule ignores the depth and liquidity of the short-term listed futures and options market. During the crisis futures and equity markets continued to function and remained liquid. This market depth and liquidity extends to the short-term listed futures and options markets. Market participants were able to roll options and futures contracts throughout the crisis period. Hence, the contractual maturity of these instruments is not relevant in assessing the maturity of the underlying long or short position.

From a fixed income perspective, liquid markets exist in many areas such as for subordinated bank debt that could classify as eligible regulatory capital for either Tier 1 and Tier 2 capital under Basel III rules. Banks have both physical (direct or indirect) and synthetic exposures to capital instruments in their trading books. Such exposures also include subordinated credit derivatives under the terms of which it
might be possible for buyers of protection to deliver capital instruments in a credit event. For these liquid and mature markets, similar to equities, it will be impossible to achieve an exact matching of maturities, particularly if hedges are entered through standardised products such as exchange-traded derivatives and indices with quarterly expiries.

In addition, since the extent of maturity mismatch in a trading book is already addressed in market risk capital requirements, we do not believe that the same risk needs to be addressed here, or is a relevant criterion for assessing the amount of double-counting of regulatory capital in, or the wider interconnectedness of, the financial system, given the liquidity of these markets.
Annex 2: Amendments to FAQs in BCBS 211

Paragraphs 78–89 (Investments in own shares, investments in the capital of banking financial and insurance entities and threshold deductions)

8. Regarding paragraphs 80 to 84, to what extent can long and short positions be netted for the purpose of computing the regulatory adjustments applying to investments in banking, financial and insurance entities?

There is no restriction on the extent to which a short position can net a long position for the purposes of determining the size of the exposure to be deducted subject to the short position meets the requirements set out in paragraphs 80-84. A short position can be used to offset a long position if all of the following conditions are met: (1) both the long position and the short position are held in the trading book; (2) the positions are fair valued on the bank’s balance sheet; and (3) the hedge is recognised as effective under the bank’s internal control processes assessed by supervisors.

9. Regarding paragraphs 80 to 84, how should exposures to the capital of other financial institutions be valued for the purpose of determining the amount to be subject to the threshold deduction treatment?

Exposures should be valued according to their valuation on the balance sheet of the bank. In this way the exposure captured represents the amount of loss to Common Equity Tier 1 that the bank would suffer if assuming the capital of the financial institution is written-off as at the balance sheet date.

13. For investments in own shares through holdings of index securities, banks may net gross long positions against short positions in the same underlying index. Can the same approach be applied to investments in unconsolidated financial entities?
For both investments in own shares and investments in unconsolidated financial entities that result from holdings of index securities, banks are permitted to net gross long positions against short positions in the same underlying index as long as the maturity of the short position matches the maturity of the long position or has a residual maturity of at least one year. However, as set out above, a short position can be used to offset a long position if all of the following conditions are met: (1) both the long position and the short position are held in the trading book; (2) the positions are fair valued on the bank’s balance sheet; and (3) the hedge is recognised as effective under the bank’s internal control processes assessed by supervisors.

17. Consider a bank that invests in an equity position (a long position) and sells it forward (a short position) to another bank (with maturity of forward sale below one year). Is it correct that both banks in this example will include a long position on the equity exposure, i.e., the selling bank cannot net the forward sale (as it has less than one year maturity) and the buying bank must recognise the forward purchase (as all long positions are added irrespective of maturity)? Also, given the fact that cash equity has no legal maturity, how does the maturity matching requirement apply?

In the example both banks will be considered to have long positions on the equity exposure unless the conditions set out in FAQ 8 above are met. Furthermore, the Basel III rules require that the maturity of the short position must either match the maturity of the long position or have a residual maturity of at least one year. Therefore, in the case of cash equity positions the short position must have a residual maturity of at least one year to be considered to offset the cash equity position. However, after considering this issue, the Basel Committee has concluded that, for positions in the trading book, if the bank has a contractual right/obligation to sell a long position at a specific point in time and the counterparty in the contract has an obligation to purchase the long position if the bank exercises its right to sell (or indeed if the economic equivalent exists), this point in time may be treated as the maturity of the long position. Therefore, if these conditions are met, the maturity of
the long position and the short position are deemed to be matched even if the maturity of the short position is within one year.