Finance Norway

European Commission
Directorate-General for Financial Stability,
Financial Services and Capital Markets Union
SPA 2 04/064
1049 Brussels
Belgium

Date: 20.06.2016
Our ref.: 16-730
Your ref.:

CONSULTATION: PROPORTIONALITY IN THE FUTURE MARKET RISK CAPITAL REQUIREMENTS AND THE REVIEW OF THE ORIGINAL EXPOSURE METHOD

On behalf of the Norwegian financial industry, Finance Norway welcomes the opportunity to comment on the Commission consultation on *proportionality in the future market risk capital requirements and the review of the original exposure method*.

The regulatory changes over the last years have generally increased significantly the regulatory burden and the compliance costs for the financial industry. The BCBS FRTB and SA-CCR add to that burden and complexity, particularly for smaller and medium sized banks and for other banks with small trading books and/or limited derivative exposures. The Norwegian financial industry consists of, in addition to the larger firms, a reasonable number of small and medium sized firms. From the point of view of the Norwegian financial industry the concept of proportionality is therefore a very important concept. In Norway, and probably in many other countries, the diversity of the financial sector created by a reasonable number of smaller and medium sized institutions is deemed to work positively for the competition in the financial sector. Thus, it is in our view important to secure that regulatory issues do not become too burdensome and complex for small and medium sized institutions. Appropriate risk management actions and use of risk mitigating techniques might also be harmed as banks might refrain from hedging activities due to the standards complexity.

On the other hand, risk sensitivity is generally good when it comes to standards for calculating capital requirements. The BCBS FRTB and SA-CCR introduces an increased level of risk sensitivity into those calculations, which should be looked upon as positive. However, increased risk sensitivity comes at a cost as described above. Therefore, Finance Norway welcomes ideas in order to give smaller and medium sized banks and other banks with small trading books and/or limited derivative exposures the opportunity to choose more simplified approaches, but still approaches with a minimum of risk sensitivity retained.

Against this background we would like to share with you the following remarks on the specific issues for consultation:

1. Can the new standardised approach in the BCBS FRTB framework be easily applied to all institutions with a trading book? If not, which elements of this approach would be more challenging to implement and for which types of trading books? If possible, please provide a quantification of potential implementation costs for the institution concerned.

The BCBS FRTB framework is a much more risk sensitive approach than the current framework for market risk. Risk sensitivity is a preferred approach. However, the increased risk sensitivity comes at a cost. The FRTB framework is assessed as far more complex than the existing approach. For small banks especially, but generally for all banks with small trading books, the increased costs can't be viewed to create a sufficient benefit either for the banks themselves or in relation to financial stability considerations. The reason for this is that the capital requirement generated by the trading book normally is small compared to the total capital requirement for such banks. At the same time, for smaller banks the struggle to implement the necessary solutions will probable create relatively high costs compared to the benefits.

We do also recognize that FRTB (standardized approach) is not only more complex to implement and maintain, but also considerably more capital intensive compared to the current standardized method. Regardless which hurdle is superior (complexity or capital intensity) these will act as barrier to trading activity, decreasing liquidity in already relatively thin markets.

2. In case the new BCBS standardised approach from Basel is not considered an adequate framework for all institutions with a trading book, which of the following three alternatives would be considered the most appropriate framework to deal with smaller or simpler trading books and why?

> ***a. The current treatment under the derogation for small trading books with increased thresholds and potentially the necessary clarifications and reviews described above;***
> ***b. a simpler standardised approach;***
> ***c. a combination of the former two elements with potentially two different thresholds.***

Please, also specify, for the alternative chosen, which considerations have to be taken into account to re-calibrate the level of the threshold(s) and the appropriate calibration of the threshold(s).

We would prefer solutions c. The proposed new standardized approach for credit risk from BCBS will, if implemented as described in the consultation of December 2015, increase the risk weights also for equities, etc. This reduces the need for handling smaller trading books under the FRTB approach.

As the new definitions of trading book positions might lead to more small and medium sized banks having a regulatory trading book than today, it is our opinion that the threshold for the derogation should be reassessed in order to prevent unintended consequences. It would probably also be a meaningful way forward to offer medium sized trading book banks an option to treat their trading books according to a simplified approach as the effects upon the total own funds requirements would not be material. However, any unintended effects of such an option could be handled through the pillar 2 process.

It should also be taken into account that the tresholds do not apply for positions in FX and commodities. Also for these types of positions the calculations methods are much more complex under FRTB. Smaller and less complex banks might have smaller FX positions also. We would therefore propose that a simplified (e.g. the current approach) should be allowed to be used for at least banks with non-significant FX positions. A specific threshold then needs to be implemented for FX positions. Commodities positions might however not be so typical for such banks, reducing the need for a specific commodities treshold.

3. In case option b) or c) have been chosen, which of these two possibilities would be considered the most appropriate regime for institutions with smaller or simpler trading books;

> ***a. a simplified version of the new standardised approach, to be developed; or***
> ***b. the current standardised approach?***

Please, justify your answer from a cost-benefit perspective. If a) is chosen, please specify which simplifications to the FRTB standardised approach would need to be performed.

We would prefer solutions b as that would create the lowest costs for the banks. In our opinion, it would not add value to create a third solution that adds (some degree of increased) complexity without creating the same level of risk sensitivity as the full version of FRTB would.

4. Please, indicate which of the two conditions provided in Article 94 of the CRR is currently more constraining for your institution, supporting your answer with data reflecting the evolution of total trading exposures in balance sheet.

Today most Norwegian banks with small portfolios of financial instruments do not have any trading intent, so the tresholds do not represent any constraints. However, with the new definition of trading books more banks might be within the definition of trading book positions. As their portfolios normally do not change much over the time horizon, the lowest of the two tresholds (i.e. the "normal level") should also normally be seen as the most constraining.

5. Besides the level of the thresholds, do you agree with the previous analysis on the other elements of the derogation for small trading book business? Which ones would need to be addressed and how?

> ***a. The definition of the thresholds, making them more specific and harmonized as described above***
>
> ***b. the clarifications on the application of the credit risk framework to some trading exposures, especially derivatives;***

In the case of item b) please specify which clarifications/modifications would be necessary and for which trading exposures in particular. In the case of changes to a) and b), please provide some measures of quantitative impact of the modifications proposed on your institutions.

The definition of the threshold might need some clarifications, especially the term "normally". That is a subjective term, and could probably be clarified by adding for example a criteria stating that "normally" means that the size of the trading portfolio has not exceeded the threshold in more than X% of the bank days since the last reporting date.

6. For those institutions that currently use the OEM, do you see any merits in replacing the OEM with the SA-CCR in the prudential framework? Would the operational difficulty to implement SA-CCR be the only impediment for your institution to the replacement of OEM by SA-CCR? Would your derivative activities be negatively impacted by the introduction of SA-CCR due to the impact of the replacement of OEM by SA-CCR on the risk-based capital requirements and leverage ratio requirement?

SA-CCR is a more risk sensitive approach, which is generally good. However, the costs and benefits should always be compared against each other. For those institutions that use OEM the total derivatives / counterparty risk exposure is not significant anyway. The effects of a change from OEM to SA-CCR would therefore be of operational impact primarily as the SA-CCR is significantly more complex. Logically it would then not give any merits to change as the differences on the own funds requirements for such banks would probably only be insignificant anyway.

For smaller banks with insignificant derivatives portfolios the derivative activities will probably be heavily influenced by the introduction of the SA-CCR. Such banks, normally very small ones, would probably stop using derivatives. Such banks normally only use derivatives for hedging purposes, and stopping the activities would then increase the risk exposure for market risk (mostly general interest rate risk in the banking book) and at the same time reducing the own funds requirement (as the underlying interest rate risk in the banking book does not have any pillar 1 own funds requirement and the counterparty credit risk capital charge would be eliminated by stopping the derivative activity). That would and should not be an intended development.

7. For those institutions that see no merits in replacing the OEM with the SA-CCR, do you find it appropriate to keep the OEM in its current form, including its link to the derogation for small trading book business, its specific use for the calculating the leverage ratio and the CVA charge? If not, please explain what you would like to change in the current application of the OEM under the CRR and why. In addition, would you find it relevant to develop some limited modifications to the OEM to ensure that it is more consistent with the SA-CCR (while avoiding undue increases to the complexity of the OEM)? If yes, which modifications would you propose to the OEM to be more consistent with SA-CCR?

It might be a better idea to remove the OEM and allow the use om CEM (MtM Method) instead as the CEM introduces some more degree of risk sensitivity without increasing the complexity too much. We do not believe many banks use the OEM method, hence for simplicity it should be removed. However we do recognize that moving from OEM to SA-CCR would mean a relatively large increase in complexity. Moving from OEM to CEM however should be attainable for every bank trading derivatives.

It would not help those types of banks operationally only to keep the OEM (or CEM – please see paragraph above) for capital adequacy purposes. For Basel Leverage Ratio purposes it has been proposed that SA-CCR should be the foundation for measurement of the derivative exposures. It would be necessary still to allow the use of the same approach for leverage ratio as for risk weighted capital adequacy if the operational burdens of SA-CCR to really be relieved for such banks.

8. For those institutions that currently use either the MtM Method or the SM, do you see any merits in replacing these approaches with the SA-CCR in the prudential framework? Would the operational difficulty to implement SA-CCR be the only impediment for your institution to the replacement of these approaches by SA-CCR? Would your derivative activities be negatively impacted by the introduction of SA-CCR due to the impact of the replacement of these approaches by SA-CCR on the risk-based capital requirements and leverage ratio requirement?

Regarding the CEM, which is likely the most used method, we believe that the replacement (or update) need to be made at some point. However, from an operational perspective, following the implementation timeline of the BCBS (January 2017) is likely too optimistic for small and many medium sized banks. We therefore believe the timing of the introduction should be harmonized with the implementation of other standardized methods (market and credit risk). Possibly a simplified/modified SA-CCR/SM or CEM can be introduced alongside SA-CCR at that time (thus replacing all previous methods).

In general, and especially for non-collateralized small and medium sized client business there will be a notable risk based capital requirement impact due to the, implicitly, increased add-ons and the alpha factor (1.4). Client pricing will need to incorporate this effect and have potential consequences on corporate participation in the derivative market as well as the market liquidity as a whole. On the other hand, collateralized and cleared (interbank) trading will, appropriately so, benefit from shorter margin period of risk (MPOR) provided by the SA-CCR.

SA-CCR is a more risk sensitive approach, which is generally good. However, the SA-CCR is also a more complex method. The costs must be measured against the benefits. For smaller and medium sized banks without significant derivative portfolios / activities the operational burdens by using the SA-CCR would be the by far most important impediment. The derivatives activities could be negatively impacted. Also such banks mostly use derivatives for hedging purposes. As described above, this could increase the banks' risk exposure and at the same time reduce their pillar 1 capital requirements.

Yours sincerely
Finance Norway

Erik Johansen
Director

Are Jansrud
Chief analyst