

**Meeting Between Staff of the Federal Deposit Insurance Corporation, Federal Reserve System, Office of the Comptroller of the Currency, and Representatives from the International Swaps and Derivatives Association (“ISDA”), Securities Industry and Financial Markets Association (“SIFMA”), Bank of America, Bank of New York – Mellon, BNP Paribas, Citi, Goldman Sachs, JP Morgan, Morgan Stanley, State Street, Sullivan & Cromwell, and Wells Fargo**

**November 2, 2023**

**Participants:**

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**Summary:** Staffs of the Federal Deposit Insurance Corporation, Federal Reserve System, and Office of the Comptroller of the Currency (collectively, the “agencies”) met with representatives from the International Swaps and Derivatives Association (“ISDA”) and Securities Industry and Financial Markets Association (“SIFMA”) and their member banks (collectively, the “ISDA and SIFMA representatives”) regarding the agencies’ Notice of Proposed Rulemaking on Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity (FDIC RIN 3064–AF29) (the “NPR”), which was published in the Federal Register on September 18, 2023 (88 FR 64028). The ISDA and SIFMA representatives discussed their concerns with, and the impact of, different aspects of the NPR on the derivatives markets and the securities industry and recommendations for changes to the NPR. They provided the attached slide deck and indicated that they intend to also submit a public comment.

# U.S. Basel III Endgame NPR Meeting with U.S. Agencies

**November 2<sup>nd</sup>, 2023**

## Disclaimer

The proposals contained within this document are still in draft. The industry is still working to finalize positions based on working group discussions and QIS data (which is still pending).

## Agenda

Slide (s) #	Topics	Sub-topics
5-10	Securities Financing Transactions / Counterparty Credit Risk	<ul style="list-style-type: none"> <li>• SFT Minimum Haircut Floor</li> <li>• SFT Collateral Haircut Approach</li> <li>• Other Counterparty Credit Risk Issues</li> </ul>
12	Overall Trading Book Impact	<ul style="list-style-type: none"> <li>• Summary of Impacts</li> </ul>
14-19	FRTB – Diversification Issues	<ul style="list-style-type: none"> <li>• Non-modellable Risk Factors</li> <li>• Modelled Capital Formula Changes</li> <li>• SA Diversification</li> </ul>
21	FRTB – Model Validation Issues	<ul style="list-style-type: none"> <li>• Desk-Level Eligibility (PLAT, Backtesting)</li> </ul>
23-35	FRTB – Additional Calibration Issues	<ul style="list-style-type: none"> <li>• Credit Spread Risk for GSEs</li> <li>• Term Repo-Style Transactions</li> <li>• DRC Issues</li> <li>• Equity Investments in Funds</li> <li>• Sovereigns in SA-DRC and SBM</li> <li>• CTP Decomposition</li> <li>• Other Areas of Concern</li> </ul>
37-39	CVA	<ul style="list-style-type: none"> <li>• CVA Financials Risk Bucket</li> <li>• CVA Scope</li> <li>• CVA Hedge Recognition</li> </ul>
41-42	Operational Challenges and Cost / Complexity	
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# Securities Financing Transactions / Counterparty Credit Risk – Additional Calibration Issues

## Securities Financing Transactions (SFTs) - Minimum Haircut Floor

- Industry discussions are focused on various aspects of the SFT Haircut Floor issues in the U.S. proposal and definitive views have not yet been reached
- However, at this stage, we anticipate raising comments in at least four areas:
  - Rationale for Inclusion: We do not believe that the Floor should be included in the final B3EG framework, particularly with no major peer jurisdiction choosing to implement it.
  - Securities Borrowing Exclusion: Notwithstanding the decision to propose a Floor, we appreciate the Agencies' inclusion of a securities borrowing exclusion in the proposal. However, as drafted, the exclusion may lead to confusion and uncertain application. We expect to raise comments on (a) the eligibility criteria (current or anticipated demand) and (b) the sufficient written documentation requirement.
  - Minimum Haircut Calibration: The calibration of minimum haircuts should be amended, in particular as it relates to sovereign collateral that is not subject to 0% risk weight under the credit risk framework and GSE collateral
  - Calculation Mechanics: If a Floor is adopted in the final rule, we believe that the calculation mechanics should be revised to account for both financial and non-financial collateral in the single transaction calculation and other technical matters. In our view, these issues, while important, are technical clarifications to ensure that the calculation mechanics are correctly calibrated to avoid false-negatives.

## Securities Financing Transactions (SFTs) - Minimum Haircut Floor

### Issues:

#### Rationale for Inclusion

- We do not believe that there are compelling reasons for adopting the SFT Haircut Floor framework in the United States
- Considerations:
  - None of the EU, UK or Japan have proposed to implement the Floor. It is unclear why U.S. market or regulatory conditions warrant a different regulatory standard.
  - There is no market or supervisory evidence cited in the proposal to justify imposition of the Floor. Other than being an element of the global Basel Accord, there does not appear to be any compelling logic for inclusion of the Floor in the U.S. regulatory capital framework.
  - The Floor does not appear to be well-designed to address potential policy concerns with financing arrangements in U.S. securities markets. As a policy tool there needs to be further consideration on the scope of application .
  - While the securities borrowing exception is helpful and welcomed, the criteria for its application introduce risks of ambiguity in practice. While we expect to suggest changes to clarify these issues, any residual ambiguity in a final rule would introduce challenges for the efficient operation of this important market.

## Securities Financing Transactions (SFTs) - Minimum Haircut Floor

### Issues:

#### **Securities Borrowing Exclusion**

- The securities borrowing exclusion, while helpful in principle, has led to questions and concerns with how it would be applied in practice.
- Section 121 (d)(2)(ii)(C) proposed text:

*“A transaction in which a [BANKING ORGANIZATION] borrows securities for the purpose of meeting a current or anticipated demand, including for delivery obligations, customer demand, or segregation requirements, and not to provide financing to the unregulated financial institution. The [BANKING ORGANIZATION] must maintain sufficient written documentation that such transaction is for the purpose of meeting a current or anticipated demand.”*

- Considerations:
  - “For the purpose of meeting a current or anticipated demand”: While this standard appears to be aligned with U.S. broker-dealer standards under Exchange Act Rule 15c3-3, it is less clear how this standard might apply to transactions conducted in non-U.S. markets where U.S. broker-dealer standards do not apply.
  - “Sufficient written documentation”: This could be read as requiring trade-by-trade documentation to match a borrowing with a particular demand for a security, which would be outside of the normal course, customary documentation.

#### **Draft Industry Recommendations:**

- Clarify that securities borrowing transactions involving non-U.S. persons/non-U.S. securities in accordance with local market requirements are exempt from application of the Floor
- Clarify that the sufficient written documentation requirement can be met through normal course books and records of the borrowing entity demonstrating its use of the borrowed security



## Securities Financing Transactions (SFTs) - Minimum Haircut Floor

### Issues:

#### Calculation Mechanics

“For a **single security-for-security repo-style** transaction,  $H$  would be defined as the ratio of the fair value of **financial collateral borrowed**, purchased subject to resale, or taken as collateral from the counterparty ( $B$ ) relative to the fair value of the **financial collateral the banking** organization has lent, sold subject to repurchase, or posted as collateral to the counterparty ( $L$ ), minus one.” 88 Fed. Reg. at 64,065-66, see Section 121 (d)(3)(ii)(B)(2)

$$H = \left( \frac{\sum C_B}{\sum C_L} \right) - 1$$

“For a **netting set of in-scope transactions**, the haircut floor of the netting set would be computed as follows: In the below formula, ( $C_L$ ) would be the fair value of the net position in each security or in cash that is net lent, sold subject to repurchase, or posted as collateral to the counterparty;  $C_B$  is the fair value of the net position that is net borrowed, purchased subject to resale, or taken as **collateral** from the counterparty; and  $f_L$  and  $f_B$  would be the haircut floors for the securities or cash, as applicable, that are **net lent and net borrowed**, respectively.” 88 Fed. Reg. at 64,066, see Section 121 (d)(3)(iii).

$$f_{Portfolio} = \left( \left( \frac{\sum(C_L / (1 + f_L))}{\sum C_L} \right) / \left( \frac{\sum(C_B / (1 + f_B))}{\sum C_B} \right) \right) - 1$$

#### Draft Industry Recommendations:

- *Recognize both financial and non-financial to the same extent, whether for a single security-for-security repo-style transaction or a netting set of in-scope transactions.* Non-financial collateral is already discounted in the E-C calculation and should not further prevent the eligibility of otherwise financial collateral. For parameter  $C_L$ , we should include both financial and non-financial collateral as well as LRM and non-LRM collateral. If not, the Industry would recommend to exclude the entire SFT trade involving non-LRM collateral from both  $C_B$  and  $C_L$
- If a netting set that contains in-scope and out-of-scope transactions fails the haircut floor, confirm that the bank can continue to recognize collateral of out-of-scope transactions

## SFT Collateral Haircut Approach

### Issues:

- Financial Collateral
  - Under the NPR, the issuer of a corporate debt security (or its parent) would be required to have publicly traded securities outstanding in order to qualify as financial collateral for the purposes of calculating risk-weighted assets for securities financing transactions under the expanded risk-based approach. This proposed approach would not be appropriate given that there are other aspects of the NPR that address the liquidity characteristics of collateral. Moreover, a listing requirement may not be particularly relevant to the liquidity characteristics of an instrument.
  - Regarding the publicly traded condition within the context of collateralized transaction, the rule text should specify that for any convertible/exchangeable instruments into listed shares (e.g., convertible bonds), the requirement of publicly traded is looking at the underlying equity and is not looking at the convertible instrument issue itself (note: US converts are not listed).
  - Financial collateral should include all sovereign debt securities eligible for a 0% risk weight.
- Revised Market Volatility Haircuts
  - US Agency debt should be subject to lower market price volatility haircuts than the haircuts that would generally apply to debt securities under the NPR in light of the important function that GSEs play in the U.S. financial system, their higher credit quality and the liquidity characteristics of their securities.
  - The proposed haircuts should apply to all permitted collateral including the collateral securing a repo-style transaction included in the banking organization's measure for market risk under Subpart F of the capital rules that are used as collateral in the collateral haircut approach for purpose of calculating risk-weighted assets for securities financing transactions. They should not be considered as "other exposures types".
  - Banks should have the option to look-through to determine the haircut of ETFs focusing on the underlying holdings of the ETF similar to mutual funds.
- Application of Collateral Haircut Approach
  - The NPR introduces a new collateral haircut formula for a "netting set of eligible margin loans or repo-style transactions" that recognizes a certain degree of diversification benefits. Generally, margin loans are accounted for as a single unit of account without any consideration of multiple loans. In this context, the industry wants to confirm that this revised collateral haircut approach can be applied to margin loans, even if they are accounted for as a single unit of account.

## Other Counterparty Credit Risk Issues

### Issues:

- Bankruptcy remote collateral
  - The securities borrower as an economic matter should not be required to treat the collateral pledged to a third-party custodial account that is bankruptcy remote as an exposure for regulatory capital purposes.
- QMNA Formula
  - The count of largest individual Es and number of instruments N of the formula need to be revised to avoid skewed results. Government securities should not be counted as largest individual Es.
- Alignment of Equity Supervisory Factors Under SA-CCR with FRTB
  - The SA-CCR final rule mentioned that the equity supervisory factors could potentially be revised to align with equity risk weights under FRTB. The industry suggests to align the SA-CCR equity supervisory factors with FRTB by adding another supervisory factor for liquid market economy equities

# Overall Trading Book Impact

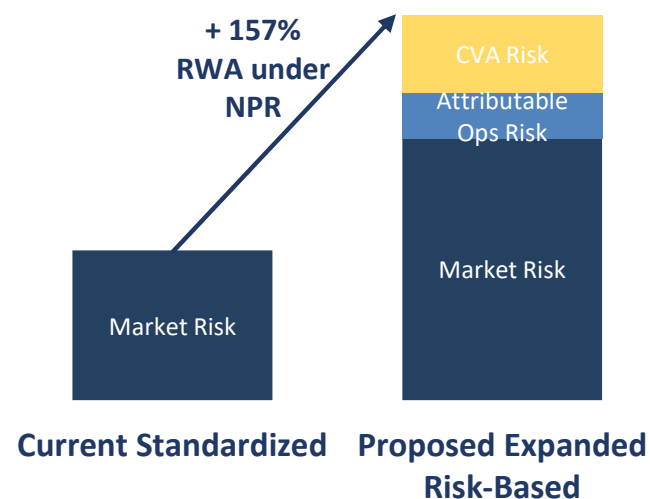
## Summary of Impact on Trading Activities

- The capital markets in the US are the largest in the world and continue to be the deepest, most liquid, and most efficient.
- In the US, capital markets fuel the economy, providing 71.9% of equity and debt financing for non-financial corporations.
- The expanded risk-based approach is expected to generally replace the current Standardized Approach as the binding capital constraint for large banking organizations with significant trading activities.
- Based on the year-end of 2021 data and QIS reports of large banking organizations, the US Agencies estimate that the increase in RWA associated with trading activity (market risk RWA, CVA risk RWA, and attributable operational risk RWA) would be around **\$880 billion**<sup>1</sup> for large holding companies relative to the Current US Standardized Approach. This translates to an overall increase of **157%** for trading activities.

### Trading Activity - RWA Impact associated with moving from US-SA to ERBA as a Total Capital Binding Requirement

	Basel III Proposed (\$bn)	Current US Standardized (\$bn)	Difference (\$bn)	Increase (%)
Market Risk*	980	560	420	75%
CVA Risk*	288	0	288	-
Attributable operational risk	172	0	172	-
Total	1440	560	880	157%

\* Table 1. Risk-weighted Assets (RWA) by Risk Category (\$ Billion, year-end 2021), Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity



<sup>1</sup> 88 Fed. Reg. at 64,170.

# FRTB - Diversification Issues

## Summary of Diversification Issues

### Issues:

- The diversification loss in FRTB is caused by various aspects of the rule such as:
  - SA: Lack of diversification across delta, vega, and curvature risk types, and across asset classes, in SA
  - IMA: Limited diversification allowed in ES and SES calculations and the lack of diversification caused by bifurcating the risk factors into MRF and NMRF
  - SA/IMA: Bifurcating the firmwide portfolio into separate IMA and SA sets
- Addressing the following will help to mitigate the impact due to the lack of diversification:
  - Introduction of an inter risk-class correlation parameter in SA to account for the benefits of diversification across risk classes
  - NMRFs which can be included in ES should be capitalized differently from NMRFs which cannot be included in ES
  - At the firm level, cap total modelled capital at the SA capital
  - Recalibration of the rho parameter in ES/SES to address the lack of diversification

## Non-modellable Risk Factors (NMRFs)

### Issues:

- NMRF capital requirements represent a significant proportion of the expected increase in market risk capital requirements and generally decrease incentives for banking organizations to apply for FRTB-IMA
- The framework for NMRFs is not appropriately risk sensitive and does not sufficiently recognize diversification within and across asset classes

### Draft Industry Recommendations:

The US NPR gives the flexibility to include NMRF in the ES framework, which is the impetus for the following proposal:

- **Recommendation 1** - NMRFs which can be included in ES should be capitalized differently from NMRFs which cannot be included in ES. Specifically, NMRFs should be classified further into A) those that have received approval to be included in ES, i.e., those that have sufficiently frequent data for scenario generation for ES/VaR models and pass ES data principles, and B) those have not received such approval.
  - Those NMRFs that are approved for inclusion in ES should be capitalized via ES with a liquidity horizon that is one notch higher than the corresponding one for MRFs (capped at 120) and excluded from SES capitalization.
  - NMRFs that are not approved for inclusion in ES would continue to be capitalized via the SES square-root-summation formula
  - Consistent with above recommendation, the process for selecting the ES stress window would maximize the ES including those NMRFs that are approved for inclusion in ES
  - We expect that the above recommendation will make the IMA capital framework more risk-sensitive, and better recognize diversification
  - The recommendation will ensure that the ES and NMRF SES portions are better balanced, maintain close alignment between internal risk management models and those used for capital, and create a better incentive for banking organizations to apply for FRTB-IMA.



## Non-modellable Risk Factors (NMRFs)

### Draft Industry Recommendations (continued):

- **Recommendation 2** – The stress window to be used for calculating SES should be aligned with the stress window used for (unconstrained) ES to reduce the operational complexity of calculating multiple stress windows
- **Recommendation 3** – The option to calculate SES at the NMRF bucket level should be restored, in line with BCBS standards. Ref BCBS MAR 33.16 – *“Subject to supervisory approval, a bank may be permitted to calculate stress scenario capital requirements at the bucket level (using the same buckets that the bank uses to disprove modellability, per [MAR31.16]) for risk factors that belong to curves, surfaces or cubes (i.e., a single stress scenario capital requirement for all the NMRFs that belong to the same bucket).”*
- **Recommendation 4** - The SES calculation would not permit a bank to aggregate non-modellable idiosyncratic risk factors except with respect to CSR and equities. We recommend that a bank should be permitted to aggregate other types of non-modellable idiosyncratic risk factors.

## Modelled Capital Formula Changes - Application of Cap

### Issues:

- The banks continue to face challenges in understanding the capital outcomes of IMA, ability to obtain and maintain a desk's model approval and concerns about the high levels of NMRF capital. Knowing that IMA capital is capped will allow banks to make investments into using modelled approach without concerns for non-economic or other unforeseen capital outcomes.
- FRTB's SA is considered by the agencies as a credible, risk sensitive capital measure that banks may choose to use and therefore may choose not to pursue IMA. However, incentivizing IMA benefits both banks and supervisors as it is likely to lead to further understanding of market risks, models risks, and P&L processes that are all fundamental to strong risk management. The ongoing review of IMA capital drivers and results would also help the supervisors in re-calibrating SA in future.

### Draft Industry Recommendations:

- The industry proposes that the formula to calculate FRTB capital for global portfolio should be updated to apply a cap of SA capital. This can be achieved with the removal of the second term in the formula  $\max((IMA_{G,A} - SA_{G,A}), 0)$  that adds back the differential between the modelled capital and standardized capital for the desks in modelled scope.
- Hence, the industry proposes the following capital formula for computation of FRTB capital for the global portfolio (note that  $DRC_{all desks}$  is defined in the next slide):

$$IMA_{total} = \min((IMA_{G,A} + PLA\ addon + SA_U), SA_{all desks}) + fallback\ capital + capital\ addons + DRC_{all desks}$$

## Modelled Capital Formula Changes - Split of DRC

### Issues:

- The FRTB capital formula at firm level splits the default risk charge into separate computations for modelled desks and non-modelled desks. This split is unnecessary and uneconomic for modelled scope (vs standardized scope) since there is only a single default risk charge methodology available under the US rules. Furthermore, splitting default risk charge undermines the effectiveness of standardized approach cap.

### Draft Industry Recommendations:

- The rules should allow the same natural diversification in default risk charge across all desks consistently irrespective of whether a bank chooses to apply for modelled scope or decides to go ahead with standardized approach for all the desks. Hence, the requirement to split the default risk charge computation under modelled scope should be removed.
- Hence, the industry proposes the following updated capital formula post removal of the 2<sup>nd</sup> term  $\max((IMA_{G,A} - SA_{G,A}), 0)$ , for computation of FRTB capital for the global portfolio:

$$IMA_{total} = \min\left((IMA_{G,A} + PLA\ addon + SA_U), SA_{all\ desks}\right) + fallback\ capital + capital\ addons + DRC_{all\ desks}$$

Where,

$IMA_{G,A}$  is 'IMCC + SES' capital for modelled desks that are in Green or Amber zone;

$SA_U$  is the 'SBM + RRAO' capital for model-ineligible desks;

$SA_{all\ desks}$  is the 'SBM + RRAO' capital for global portfolio

$DRC_{all\ desks}$  is the default risk charge capital for global portfolio

## SA Diversification

### Issues:

- FRTB SA's SBM, by design, does not recognize any diversification between asset classes (risk class-levels).
- We do not believe that the absence of any diversification benefit in FRTB SA is backed by publicly available evidence. For instance – in banks' pillar 3 disclosures significant diversification across asset classes can be inferred by comparing the VaR by asset classes with the diversified VaR

### Draft Industry Recommendations:

- We propose introducing a correlation parameter across risk class-levels within SBM, using similar mathematical forms as existing aggregations within asset classes:

$$\text{capital requirement} = \sqrt{\sum_b SBM_b^2 + \sum_b \sum_{c \neq b} \rho_{bc} SBM_b SBM_c} + DRC + RRAO$$

- $SBM_b$  is the risk class-level capital requirement for each of the 7 asset classes: GIRR, Equity, FX, Commodities, Credit (non-sec, non-CTP), Credit (sec, non-CTP), and credit (CTP)
- $\rho_{bc}$  is a new inter asset correlation parameter or parameter set (effectively set to 100% in BCBS and NPR)

# FRTB - Model Validation Issues

## Desk-Level Eligibility (PLAT, Back-testing)

### Issues:

- In principle, we believe the regulatory framework should encourage firms to pursue IMA
  - While SA calculations are mandatory, IMA calculations raise the prospect of improved risk-sensitivity, increase the analytics buttressing FRTB, and can assist with risk management
- PLAT has been a long-standing concern for the industry due to implementation challenges as well as conceptual issues (e.g., testing the entire distribution while capitalization is based only on the tail of the distribution)
  - As a result, banks have deprioritized Day 1 IMA capabilities
- In addition, for firms that plan to pursue IMA for Day 1, there is an ongoing concern that PLAT failure may result, in turbulent periods, in IMA disqualifications
  - There are capital planning concerns with “springing” capital increases from sudden, unanticipated loss of IMA

### Draft Industry Recommendations:

- We encourage the Agencies to change the PLA requirements to align with the approach used in the current rule regarding significant sub-portfolio backtesting, namely
  1. Banks would be required to report the Spearman correlation metric and the Kolmogorov-Smirnov metric for each IMA desk to the agencies on a quarterly basis. These results can be used by the agencies, for example, to monitor practices across banks or to initiate horizontal or bank-specific reviews
  2. The requirement to test each metric against a threshold would be removed and would not be part of determining a desk’s IMA eligibility and RAG status. Desk level backtesting would remain and would be the sole determinant of a desk’s RAG status.
- Recognizing the newness of banks’ implementations and the untested nature of PLAT for both banks and regulators, this approach will further incentivize banks to pursue IMA

# FRTB - Additional Calibration Issues

## Credit Spread Risk for Government Sponsored Entities (GSEs)

### Issues:

- The treatment of GSEs (i.e., UMBS-eligible securities and non-UMBS eligible instruments issued by Fannie Mae and Freddie Mac) in the calculation of credit spread risk in SBM is of particular concern. The rule implies that UMBS-eligible securities should be treated as a separate name from securities issued by Fannie Mae and Freddie Mac and therefore would require a very low standard 35% intra-bucket correlation factor for the market risk capital calculation
- The proposed treatment does not appropriately capture the associated risk and is inconsistent with the FHIA Single Security Initiative and Common Securitization Platform, and the creation of Uniform Mortgage-Backed Securities (UMBS)
- The proposed treatment under the NPR of GSEs that precludes risk appropriate offsetting would have harmful effects on end users as it would increase the capital requirement for banks that may result into negative impact for individuals seeking mortgages for home ownership

### Draft Industry Recommendations:

- The final rule should reflect the unique nature of US GSEs between and among UMBS, Fannie Mae, and Freddie Mac under both SBM and DRC:
  - TBAs and Deliverable Pools that are UMBS-eligible should be treated as the same obligor
  - UMBS and UMBS-ineligible Fannie Mae/Freddie Mac securities should be considered the same obligor if the issuer names are the same



## Term Repo-Style Transactions

### Issues:

- While the NPR continues to allow a bank to include term repo-style transactions in market risk NPR wording requires a bank to reflect not only the cash leg (as done currently) but also the security leg or gold in market risk (i.e. see page 64148 that says *“the proposal would require a banking organization to capture the risk factor sensitivities of the cash leg to general interest rate risk and of the security leg to credit spread risk, equity risk, commodity risk, and foreign exchange risk, as applicable. The proposal would also require a banking organization to separately calculate the standardized default risk capital requirement to capture losses on the underlying reference exposure in the event of issuer default.”*)
- This requirement of including the collateral leg in market risk is a fundamental departure from what is considered market risk exposure and therefore creates a material disconnect between the capital calculation and economic market risk profile
  - The market price risk of an RST is solely to the relevant interest rate and repo spread. The Bank does **not** face direct **market price risk** or **issuer-default risk** on the security collateral of the RST. The bank only faces **contingent** (i.e., contingent upon the default of the counterparty) price risk which is **never included in market risk** and always captured via the exposure at default (EAD) calculation, in particular volatility haircuts, under the counterparty credit risk RWA charge.
  - This is **consistent with the accounting treatment** – under US GAAP for a Securities Financing Transaction (repos/reverse repos/securities borrowed/lent), the security used as collateral is not recognized on the balance sheet of the cash lender **as the lender has no economic interest in the security.**
- A survey of the US GSIBs shows that **none include the security leg in Basel II.5/III**

### Fatal Flaw:

- RST Banks do not face direct market price risk or issuer default risk to the security collateral of the RST. The NPR proposal to include repo collateral in Market Risk results in a material mis-statement of market risk RWA and not aligned with P&L.

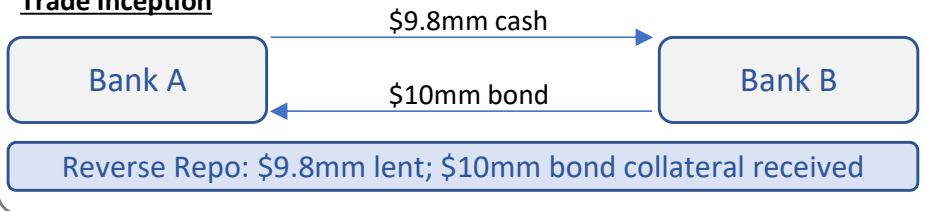
### Draft Industry Recommendations:

- The **market price risk** and **issuer default risk of the collateral** should not be included in Market Risk.
- The **market price risk** of the RST (i.e., the IR risk incorporating the repo spread) should be included in Market Risk, consistent with banks’ treatment under current rule.

## Term Repo-Style Transactions – 2 Bank Example

### Bank A Perspective: 1-month Reverse Repo (assume 0% repo rate)

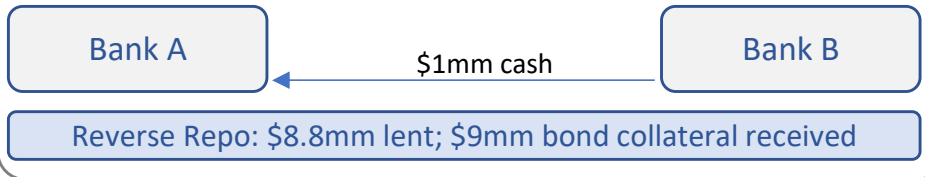
#### Trade Inception



- In this reverse repo transaction, Bank A lends cash and receives a 10y Govt bond as collateral
- The reverse repo asset is recognised on Bank A's balance sheet, the collateral is not recognised on the balance sheet – Bank A has no direct risk exposure to the collateral

#### During life of trade

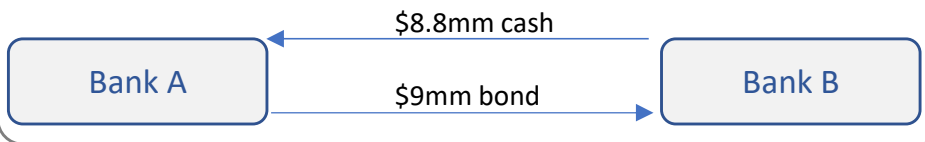
- Bond price declines by 10 points
- Bank A calls and receives \$1mm margin from Bank B



- The decline in price of the collateral triggers a margin call, but does not generate any MTM P&L for Bank A. Bank A has no direct risk exposure to the collateral
- Bank B pays the margin. If margin is not paid, the RST will be closed out and collateral sold, with no loss for Bank A

#### At maturity

- Bank A returns bond to Bank B (which is now worth \$9mm)
- Bank B repays outstanding cash (\$8.8mm) to Bank A



- At RST maturity, Bank A is repaid the outstanding \$8.8mm (netted with the margin) and has now been repaid the original \$9.8mm lent in full.
- The bond collateral is returned to Bank B.
- Bank A has been repaid in full and incurred no loss, despite the decline in value of collateral.
- **Bank A has no direct exposure to the bond collateral price**

Bank A	Reverse Repo	Bond Collateral
Balance Sheet	Asset	N/A – not recognized
P&L	0 (no change in the repo curve)	N/A – No exposure/P&L
Industry proposed FRTB RWA	\$0.2mm	N/A – No exposure
NPR FRTB RWA	\$0.2mm	\$16.2mm*

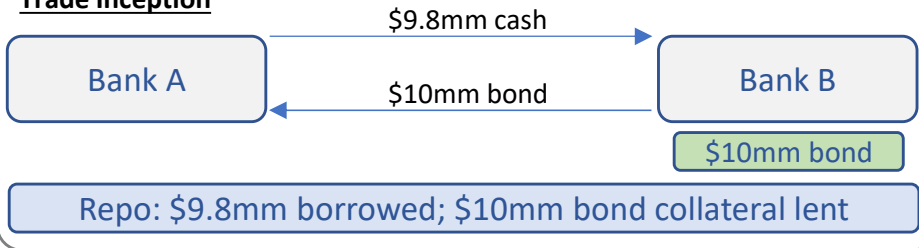
**Uneconomic treatment – NPR proposal to include collateral in MR RWA is misaligned with balance sheet, P&L and market risk exposure**

\*The method how to include term repo-style transactions in DRC is unclear and could range between \$16.2mm and \$16.6mm

## Term Repo-Style Transactions – 2 Bank Example

### Bank B Perspective: Long Bond Position + 1-month Repo (assume 0% repo rate)

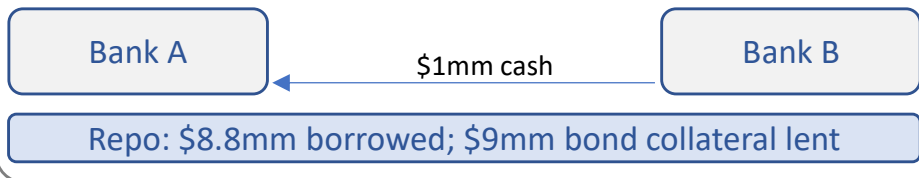
#### Trade Inception



- From the perspective of Bank B, the Bank has an existing \$10mm govt bond position in its trading book and enters into a 1-month repo with Bank A – lending the bond as collateral and borrowing \$9.8mm cash
- The repo liability is recognised on Bank B's balance sheet and the trading book bond position remains on Bank B's balance sheet. The lent bond collateral is not recognised on Bank A's balance sheet

#### During life of trade

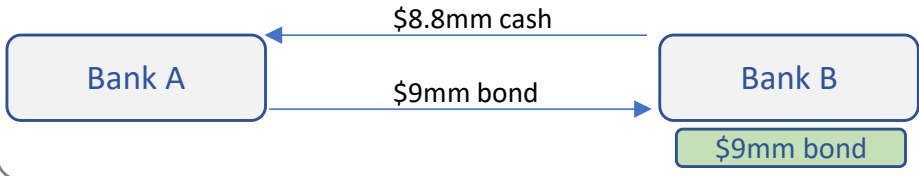
- Bond price declines by 10 points
- Bank A calls and receives \$1mm margin from Bank B



- The decline in price of the collateral triggers a margin call for Bank B to pay to Bank A
- In addition, Bank B incurs the \$1mm loss on its trading book bond position, despite having lent the bond to Bank A

#### At maturity

- Bank A returns bond to Bank B (which is now worth \$9mm)
- Bank B repays outstanding cash (\$8.8mm) to Bank A



- At RST maturity, Bank B repays the outstanding \$8.8mm (netted with the margin) and has now repaid the original \$9.8mm borrowed in full.
- The bond collateral is returned to Bank B, now valued at \$9mm
- **Bank B has incurred the loss on the bond, as it is a trading book position. The repo, and posting of bond as collateral, has no effect on this**

Bank B	Repo	Bond Position
Balance Sheet	Liability	Asset
P&L	0 (no change in the repo curve)	-\$1mm
Industry Proposed FRTB RWA	\$0.4mm	\$16.6mm
NPR FRTB RWA	\$0.4mm	\$1mm*

**Uneconomic treatment – NPR proposal to include collateral in MR RWA is misaligned with balance sheet, P&L and market risk exposure, incorrectly offsets RWA of long bond position**

\*The method how to include term repo-style transactions in DRC is unclear and could range between \$0mm and \$1mm

## Default Risk Charge Issues

### Issue 1:

- Banks facilitate longer dated derivatives (e.g., equity swap 1 year) and hedge with cash position (e.g., equity stock) or shorter dated derivatives (e.g., equity future 3m)
- The trade is penalized under FRTB SA-DRC due to maturity scaling. To prevent broken hedges, the proposal would allow banks to assign the same maturity to a cash position as the maturity of the derivative it hedges (permit full offsetting). However, for shorter dated derivatives hedging longer dated derivative, banks are not allowed to align the maturities (full offsetting disallowed)

### Draft Industry Recommendation:

- The proposed rule for SA-DRC should expand maturity alignment available to cash vs. derivative transactions to derivative vs derivative hedging transactions as well. The shorter dated derivatives can be more effective hedges with higher liquidity than cash positions and allow banks to better risk manage.

### Issue 2:

- For derivatives with Optional Early Termination (“OET”) feature (e.g., equity swaps), effective maturity can be significantly shorter than stated maturity, given both counterparties can terminate the trade much earlier (e.g., terminate at any day)
- The rule does not clarify that OET can be used for maturity calculation in these cases

### Draft Industry Recommendation:

- The proposed rule should recognize Optional Early Termination (“OET”) date for maturity calculation where effective duration risk is shorter than stated maturity

## Equity Investments in Funds (FRTB-SA)

### Issues:

- The capital treatment of funds remains problematic and uneconomic under the FRTB framework. While some improvements have been made under IMA, most of the approaches in the standardized rules remain unimplementable and the banks will be forced to apply the fallback approach for a majority of the fund population.
- Under IMA a bank can apply an alternate modelling approach subject to supervisory approval, but this provision does not exist in SA. Also, under the Hypothetical Portfolio, a bank is allowed to diversify the risks of the fund with other instruments in a modelled desk but will have to compute a standalone capital for the fund in a desk that uses SA.
- The treatment of funds is further exacerbated in the DRC where despite the application of simple (but highly punitive) fallback approach in SBM, a bank will have to review the mandate of each fund to: (a) find the worst risk weight by assuming that the fund invests to the maximum extent in exposures with highest risk weights, and (b) determine whether the risk weight applied to the fund is prudent or if RRAO must apply. This treatment is operationally very cumbersome.
- SA rules must be appropriate for funds as it has to be applied for all desks irrespective of a bank's selection of IMA. It would also not be possible for the banks to apply for IMA for desks holding funds (e.g., due to poor model performance) hence SA must provide a credible fallback mechanism. Also, SA serves as cap in the global portfolio capital formula, hence, it needs to be appropriately calibrated to serve this purpose.

### Draft Industry Recommendations:

- Under the proposed hypothetical portfolio approach under the standardized rules, a bank should be permitted to diversify the exposures on a fund with exposures from other instruments.
- The rules should allow banks the option to allocate a fund to an appropriate index bucket without having to decompose it.
- Similar to IMA, subject to supervisory approval, an alternate modelling approach should be permitted under SA
- For the treatment of funds in DRC, a fallback approach should be allowed to treat the exposures on a fund as a single name 'speculative' equity exposure and diversification should be allowed with other default exposures.

## Equity Investments in Funds - BOLI / COLI

### Issues:

- The NPR requires equity positions in investment funds to be treated as market risk covered positions if the firm has access to the investment fund’s prospectus, partnership agreement, or similar contract that defines the fund’s permissible investments and investment limits; and either:
  - i. The firm is able to use the look-through approach to calculate a market risk capital requirement, or
  - ii. The firm obtains daily price quotes for the investment fund
- Bank Owned Life Insurance (BOLI) and Company Owned Life Insurance (COLI) products are treated as non-trading equity exposures under current rules and banks generally apply one of the associated look through approaches
- As a result, there is a concern that the Agencies would expect that banks could “use the look-through approach to calculate a market risk capital requirement”, therefore rendering these market risk covered positions
- Conceptually we do not think BOLI and COLI products should be treated as market risk covered positions because banks do not hold these positions with any trading intent
- From a practical perspective, applying a look-through approach to calculate a market risk capital requirement under FRTB is significantly different to applying a non-trading equity exposure look through approach, and in reality would require banks to book all of the underlying positions in their systems as if they owned them directly
  - Therefore, we do not believe that the requirement (i) above would be met
- As of 30<sup>th</sup> Jun 2023, US banks held \$184.6B of BOLI cash value\*. If these were required to be classified as covered positions, assuming banks apply the fallback approach, this would translate into ~\$1.6T RWA in FRTB SA, which would be approximately ten times current RWA

### Draft Industry Recommendations:

- We recommend that BOLI and COLI products be explicitly excluded from the definition of a market risk covered position, similar to other existing carve-outs which exist such as “equity positions arising from deferred compensation plans, employee stock ownership plans, and retirement plans”

\* <https://www.bolicoli.com/bank-owned-life-insurance-facts-and-figures/>

## Sovereigns in SA-DRC

### Issues:

- Under the proposal, all non-US sovereign exposures, and exposures to Supranationals would be subject to a nonzero risk weight under the standardized default risk (SA DRC) capital requirement
- Highly rated sovereign exposures currently receive 0% risk weight under the US standardized specific risk rules, and consequently, the proposed approach would have adverse effects on the liquidity and functioning of markets for sovereign and supranational exposures by increasing the market risk capital requirements for these securities
- Additionally, local currency sovereign exposures in which the material risk is currency devaluation, and there is an equivalent amount of local currency liabilities to effectively offset that risk, also currently receive 0% risk weight (if permitted under local regulations), and while this provision has also been carried over to the Credit Risk Rules in the US NPR, it has not been incorporated into the Market Risk Rules. This would cause inconsistencies between Market Risk and Credit Risk treatment for the same exposures.
- Furthermore, the Rule currently assigns a single risk weight for Non-US sovereign positions based on credit quality, whereas in practice, sovereign issuances in local currency typically have higher credit ratings than foreign currency issuances (because of the risk profile differences between local vs. foreign currency debt)

### Draft Industry Recommendations:

- Exposures to Supranationals and sovereign OECD members with no CRC or sovereigns with CRC between 0-1 should be exempted from SA DRC capital requirements
- In addition, local currency sovereign exposures with equivalent amount of local currency liabilities should also be exempted from SA-DRC charges (as long as permitted by their local regulations)
- Finally, for local currency sovereign exposures which will not meet the above exemption criteria, banks should be permitted to assign risk weights based on the credit quality of the local currency issuances

## Sovereigns in SBM

### Issues:

- Under the proposal, MDB and Supranational exposures would be subject to a nonzero risk weight for credit spread risk in the Sensitivity Based Method (SBM)
- However, for pricing and risk management purposes, these types of positions are typically not considered “credit risky”, and hence, the requirement to model credit spread risk will result in additional operational challenges and complexity

### Draft Industry Recommendations:

- Exposures to certain sovereigns as defined below, MDBs, and Supranationals should be exempted from credit spread SBM capital requirements
  - All exposures to sovereigns that are OECD members with no CRC or sovereigns with CRC between 0-1
  - For all other sovereigns, exposures in local currency



## Correlation Trading Portfolio (CTP) Decomposition

### Issues:

- The Industry appreciates that the US NPR allows decomposition of indices within CTP under the sensitivities-based method (**SBM**). While the industry understands that that the rule allows decomposition under the default risk charge (**DRC**) as well, how this should be implemented remains unclear.
- **Calculation of decomposed single name default JTDs exposures:**
  - Issue 1: Page 64127 of the US NPR says that the “*decomposition into single-name equivalent exposures account for the effect of marginal defaults of the single names in the tranching correlation trading position, where ... the sum of the decomposed single name amounts would be required to be consistent with the undecomposed value of the tranching correlation trading position*”. It is unclear how to interpret the underlined requirement given that the sum of the decomposed single name based on marginal defaults of the tranche is different compared to the undecomposed value of the tranche position
  - Issue 2: As per section 210(b)(1)(iv) a bank must assign zero recovery when calculating the decomposed JTDs of multi-underlying instruments. This is inconsistent with single-underlying instruments and leads as such to incorrect net JTD results
    - The following example of a 1<sup>st</sup> to default basket (notional: \$10MM) hedged with a CDS on Name 1 (\$5MM) illustrates this:

	1 <sup>st</sup> to default basket			CDS Hedge	Combined		
Names	Marginal JTD	Undecomposed JTD	Scaled Margin JTD	Marginal JTD	Net JTD unscaled	Net JTD scaled	Net JTD (Consistent 25% recovery)
Name 1	\$10MM		\$3.3MM	-\$3.8MM	\$6.3MM	-\$0.4MM	\$3.8MM
Name 2	\$10MM	\$10MM	\$3.3MM		\$10MM	\$3.3MM	\$7.5MM
Name 3	\$10MM		\$3.3MM		\$10MM	\$3.3MM	\$7.5MM
<b>Sum</b>	<b>\$30MM</b>	<b>\$10MM</b>	<b>\$10MM</b>	<b>-\$3.8MM</b>	<b>\$26.3MM</b>	<b>\$6.3MM</b>	<b>\$18.8MM</b>

## Correlation Trading Portfolio (CTP) Decomposition

- Consistent with the rule text, decomposed JTDs must be based on marginal defaults. A scaling of the decomposed JTD to \$3.3 in this example understates the loss as a result of marginal default of the underlying obligor. For senior tranches it would overstate the decomposed JTD of the underlying obligor
- When decomposing the LGD / recovery assumption needs to be consistent with the one used for single name instruments in order that the net JTD is accurate. In the example, on the previous slide the net JTD of \$6.3MM is overstated given the inconsistent recovery assumption between the single name JTD and the decomposed JTD. \$3.8MM is based on a consistent LGD / recovery assumption and represents the accurate net JTD
- **Risk weighting / bucketing of decomposed single name exposures:** The rule does not provide any method what risk weight to assign to the net JTDs obtained via decomposition. The industry would like to confirm that banks can assign the non-securitization risk weights as per table 1 to section 210 to net JTDs by decomposed underlying name. Furthermore, the Industry wants to confirm that the bank can use the same buckets for decomposed JTDs as those applicable to non-securitization exposures as per section 210(b)(3)(i) instead of using buckets per index given that an index is not relevant for decomposed JTDs.
- **Residual Component:** The netting of decomposed single name exposures is allowed “*when the long and short gross default exposures are otherwise equivalent except for a residual component.*” The industry interprets that “except for residual component” does not impose any restriction as to when a long and a short decomposed JTD of the same obligor can be netted and simply means that after netting decomposed JTDs that any remaining decomposed net JTD needs to be capitalized along the lines outlined above

### Draft Industry Recommendations:

- Requirement to scale the sum of the decomposed JTDs to the undecomposed JTD of the tranche should be removed
- A bank should be able to assign an LGD for multi-underlying instrument consistent with the underlying instruments based on section 210(b)(1)(v)
- Allow banks to assign non-securitization risk weights to decomposed JTDs as per table 1 to section 210 and use the non-securitization buckets for aggregation purposes

## Other Areas of Concern

Topic	Description
Securitizations	<p><b>Issue:</b> The proposed changes to the securitization framework will increase DRC risk weights resulting in significantly higher MR RWA on securitization positions in the trading book due to increase in p-factor from 0.5 to 1.0 and 100% risk-weight floor for re-securitization positions. The current US Basel III rule does not recognize certain bona fide transfers of credit risk and the NPR is a missed opportunity to rectify this issue.</p> <p><b>Draft Recommendation:</b> Retain the existing 0.5 p-factor and incorporate the STS securitization framework in the US. We also recommend removing the 100% risk-weight floor for re-securitizations or incorporate the look-through approach within the NPR for both securitizations and re-securitizations. Lastly, we recommend amending the credit risk transfer rules to recognize bona-fide transfers of credit risk.</p>
Scope of Residual Risk Add-on (RRAO)	<p><b>Issue:</b> There is ambiguity in the NPR language around the definition of exotic products, and contradictions in the language between Rule and Pre-ambule regarding path dependence and options with two or fewer underliers. These ambiguities and contradictions can materially alter the scope of RRAO inclusions/exclusions, and result in inconsistent treatment across banks. In addition, the NPR still explicitly specifies a few different products to be included in RRAO, and in the industry's view, some of these products do not bear the type of residual risks that RRAO is intended to address.</p> <p><b>Draft Recommendation:</b> The language defining Exotics should be corrected. Also, for path dependence/options with 2 or fewer underliers, the language in the preamble should be made consistent with the Rule sections. Additionally, as response to Questions 133 and 134 in the NPR, the industry will provide a list of products that should be exempted from RRAO, along with associated rationale.</p>
Capital Requirements for Re-Designations	<p><b>Issue:</b> Banking book ALM function can utilize internal trading desk to purchase and sell securities at arm's length for operational and cost efficiencies. Requirements around redesignation that include documentation, calculation and tracking of capital add-on and providing supervisory notice would create significant operational burden for the flow. This would force ALM function to transact via external dealers, rather than in-house, at the cost of foregoing the operational and cost efficiencies.</p> <p><b>Draft Recommendation:</b> Where ALM desks use internal trading desk to access the market for the sale and purchase of securities of their AFS and HTM portfolios at arm's length, US rule should consider exemptions made available in the Canadian adoption and expand the scope of exemptions to all HQLA Level 1 and 2A securities from being subject to the redesignation rule.</p>

## Other Areas of Concern

Topic	Description
Covered Bonds	<p><b>Issue:</b> The US draft rules assign a 2.5 percent risk weight to covered bonds under the Sensitivity Based Measure of the FRTB Standardized Approach. The preamble indicates that “most U.S. banking organizations hold limited or no covered bonds,” such that “the proposed 2.5 percent risk weight should have an immaterial impact on the sensitivities-based capital requirements.” This characterization downplays the real inventories that U.S.’s largest banks can have to serve their clients, and therefore also underestimates the very material impacts that the higher risk weight will have.</p> <p><b>Market Statistics:</b> The market size for covered bonds is ~\$1.3 trillion just for the benchmark bonds alone. In 2022, it is estimated that US banks held nearly half (~46%) of the total DV01 market share of all banks. The impact of the US NPR proposed 2.5% risk weight versus the Basel 1.5% risk weight will result in a 67% higher RWA for the US bank holdings versus other jurisdictions.</p> <p><b>Draft Recommendation:</b> As only a single risk weight is to be chosen for covered bonds and given that the covered bonds market is almost entirely AA-rated or higher, the risk weight should be 1.5 percent (instead of 2.5% in the US NPR). It should be noted that the 1.5 percent risk weight too remains a very conservative, given the very low volatility of these instruments.</p>
REITs	<p><b>Issue:</b> To assign REITs into “other sector” is very punitive because the capital calculation doesn’t recognize the hedging benefit between long and short positions. The US NPR’s requirement to treat publicly traded REITs through the equity invest in fund path is sub-optimal. Furthermore, the US NPR is silent on the debt position of REITs.</p> <p><b>Draft Recommendation:</b> The sector classification for equity positions in REITs in Equity Risk Class (Table 8 to Section 209) should be “Financials Including Government-Backed Financials, Real Estate Activities, and Technology” rather than “Other sector”. The sector classifications for debt position in REITs in Credit Spread Non-Securitization Risk Class (Table 3 to Section 209) should be “Financials Including Government-Backed Financials.” Further, this sector should include “Real Estate Activities” to be consistent with the Equity Risk Class.</p>

# Credit Valuation Adjustment – Additional Calibration Issues

## CVA Financials Risk Bucket

### Issues:

- Under the BA-CVA and SA-CVA, financials would be assigned to bucket number 2 and subject to a risk weight of 5% for investment grade and 12% for speculative grade and sub-speculative grade exposures for purposes of the delta counterparty credit spread risk. The proposed risk weights for financials under the CVA framework are not appropriately risk sensitive

### Draft Industry Recommendations:

- There should be enhanced granularity of the risk weights applicable to financials to reflect the differences in risk profile between regulated financial institutions<sup>3</sup> and unregulated financial institutions, which is reflected in other aspects of the NPR
- Exposures to regulated financial institutions should receive a risk weight of 3% for investment grade exposures and 8.5% for non-investment grade exposures. Exposures to unregulated financial institutions should receive a risk weight of 5% for investment grade exposures and 12% for non-investment grade exposures. In addition, government pension funds should be assigned to category 1b

		Sovereigns	Local Govt.	Financials	Materials, energy, ...	Consumer goods, ...	Tech, comms, ...	Health, Utilities, ...	Other	Qualified Indices	
	<b>Bucket</b>	<b>1a</b>	<b>1b</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>	
<b>B3E NPR</b>	IG	0.50%	1.00%	5.00%	3.00%	3.00%	2.00%	1.50%	5.00%	1.50%	
	HY and NR	3.00%/7.00%	4.00%	12.00%	7.00%	8.50%	5.50%	5.00%	12.00%	5.00%	
	<b>Bucket</b>	<b>1a</b>	<b>1b</b>	<b>2a</b>	<b>2b</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>
<b>Proposed</b>	IG	0.50%	1.00%	3.00%	5.00%	3.00%	3.00%	2.00%	1.50%	5.00%	1.50%
	HY and NR	3.00%/7.00%	4.00%	8.50%	12.00%	7.00%	8.50%	5.50%	5.00%	12.00%	5.00%

Regulated Financials

Unregulated Financials

<sup>3</sup> Regulated financial institutions includes highly regulated entities (i.e., Pension 40 Act funds)

## CVA Scope - Client Facing Exposure on Cleared Transactions

### Issues:

- The proposal will require Banks to calculate CVA capital charge for its exposure to a client on a cleared transaction
- However, the client facing leg of a cleared transaction is not on the Banks' balance sheet, and hence, there is no accounting CVA calculated for it
- Consequently, Banks may not be able to model these exposures under SA-CVA, and will instead have to capitalize them under BA-CVA, which will be more punitive and not risk-aligned
- As a result, costs of central clearing would increase, which would be contrary to public policy objectives

### Draft Industry Recommendations:

- Client facing exposure on a cleared transaction should be excluded from CVA capital charge

## CVA Hedge Recognition

### Issues:

- For BA-CVA, the correlation between a single name hedge and the exposure is 100% if it references the counterparty directly, 80% if it references an affiliate of the counterparty or 50% if it belongs to the same sector / region as the counterparty
- Similarly, for intra-bucket aggregation of counterparty credit risk delta in SA-CVA, the  $\rho_{ki}(\text{name})$  parameter equals 100 percent if the two names are the same, 90 percent if the two names are distinct but are affiliates, and 50 percent otherwise;
- However, “Affiliate” is a defined term in the capital rules, and the industry is concerned that definition only applies to private sector entities, and not to a sovereign or public sector entities (PSE)
- Consequently, if there is a strong linkage between the credit quality of a counterparty (e.g., PSE or a quasi-sovereign / government-controlled entity) and a sovereign, the bank’s accounting CVA uses the sovereign CDS credit curve, and the bank uses a hedge referencing the sovereign, then that hedge will not get proper recognition
- In addition, the proposed Rules also do not provide any recognition for hedges referencing an entity, where that entity has unconditionally guaranteed the performance of the counterparty
- Finally, while for SA-CVA, section 224(d)(3)(i) or 224(d)(3)(ii) of the proposal allows for estimating or mapping the credit spread curves of an illiquid counterparty using the counterparty’s liquid peers, the counterparty and the liquid peer will still be treated as two distinct “entities”, i.e., risk factors, for counterparty credit spread delta capital calculation and aggregation
- Again, this will prevent netting of exposure when the bank uses a hedge referencing the same liquid peer, and it will be inconsistent with accounting CVA calculations, where any variation of the accounting CVA reserve is based on the spread moves of the liquid peer (and not the counterparty itself)

### Draft Industry Recommendations:

- When a bank uses a hedge referencing a sovereign for a PSE counterparty, allow 80% correlation in BA-CVA, and  $\rho_{ki}(\text{name}) = 90\%$  in SA-CVA
- Similarly, when a bank uses a hedge referencing a sovereign for a counterparty that is controlled by the sovereign, allow 80% correlation in BA-CVA, and  $\rho_{ki}(\text{name}) = 90\%$  in SA-CVA
- Furthermore, if an entity unconditionally guarantees the performance of a counterparty, then a hedge referencing that entity should get 100% correlation in BA-CVA, and  $\rho_{ki}(\text{name}) = 100\%$  in SA-CVA
- Finally, where a bank is mapping the credit spread of an illiquid counterparty using a liquid peer, the Bank should be allowed to use those same liquid peers as the “entity” for the counterparty for defining the counterparty credit spread delta risk factors in Section 225(a)(3)(ii).



# Operational Challenges

## Operational Challenges and Cost / Complexity

Topic	Description
<b>Split Netting Sets</b>	<p><b>Issue:</b> Under the NPR, a banking organization would be required to obtain prior supervisory approval in order to split a netting set into two netting sets and separately apply the BA-CVA and the SA-CVA approaches to the netting set. The requirement to obtain prior supervisory approval would not be practical in instances where the inclusion in BA-CVA might simply be the result of temporary pricing failures as part of the SA-CVA exposure simulation.</p> <p><b>Draft Recommendation:</b> No approval should be needed if the split is due to pricing failures or infrastructure issues</p>
<b>Volcker Desks</b>	<p><b>Issue:</b> As per footnote 270 of the B3 Endgame proposal the proposed definition of trading desk under FRTB is generally consistent with the definition in the Volcker Rule.</p> <p><b>Draft Recommendation:</b> A banking organization should be permitted to define a trading desk for purposes of applying the internal models approach under the market risk capital rules at a more granular level than the trading desk concept that applies under the Volcker Rule. In particular, a single Volcker Rule trading desk may engage in both non-securitization credit products —which generally would be FRTB-IMA eligible — and securitizations and other activities for which the banking organization would not apply the FRTB-IMA when calculating market risk capital requirements</p>
<b>Net Short Risk Positions</b>	<p><b>Issue:</b> The proposed net short risk position framework raises significant conceptual complexity regarding the measurement of net short risk positions (e.g., the granularity at which net short risk position would be measured and the interaction with proxy hedges)</p> <p><b>Recommendation:</b></p> <ul style="list-style-type: none"> <li>• The Industry recommends the elimination of the requirement to subject net short risk positions to the market risk framework. In general, these positions are governed by a banking organization’s credit risk management frameworks and monitoring, not by risk management frameworks responsible for positions subject to market risk capital requirements.</li> <li>• The framework still has issues dealing with transient net short positions and it is unclear how this will interact with re-designations and internal risk transfers</li> </ul>

## Operational Challenges and Cost / Complexity

Topic	Description
<p><b>Frequency of SA runs</b></p>	<p><b>Issue:</b> The US NPR requires banks to “calculate the standardized measure for market risk at least weekly” (Section __.204 , page 64236) vs Basel rules only asking for a monthly frequency (MAR 20.2). Hence the industry would like to understand the drivers behind this increased frequency, and whether these weekly estimates will be part of any binding capital requirements as this will most likely increase the implementation and operating model complexities significantly.</p> <p><b>Draft Recommendation:</b> The Standardized Approach calculations are driven off multiple disparate components that need to be collated for accurate estimates (e.g., population scope, signed-off sensitivities, stress, DE, notionals, etc.) and banks will need to apply significantly higher standards to all these components for any binding capital requirements vs using them only for internal risk and capital management purposes. Therefore, the industry would like to propose that the frequency for running standardized approach is updated to monthly in line with Basel rules.</p>
<p><b>Ineligible CVA Hedges</b></p>	<p><b>Issue:</b> The definition of a market risk covered position would include ineligible CVA hedges, i.e., the CVA segment of an internal risk transfer that is not an eligible CVA hedge, or a CVA hedge with an external party that is not an eligible CVA hedge. In addition, the US NPR has a mandatory externalization of CVA hedges with curvature, RRAO, and DRC.</p> <p><b>Recommendation:</b> It would be inappropriate to include automatically as a market risk covered position a CVA hedge that does not meet the specific requirements to be considered an eligible CVA hedge under the NPR. These hedging transactions reduce the economic risk of the banking organization and are one element of sound risk management practices. Specifically, this will unduly disincentivize BA-CVA, where the exposure hedges of CVA (e.g., interest rate hedges) are not considered eligible for CVA RWA calculation purposes</p> <p>In addition, this will also be a significant departure from the current US Basel 3 Rules. Consequently, the industry recommends that ineligible CVA hedges should not be included in scope of Market Risk covered positions. Additionally, for hedges with curvature, RRAO, and DRC, there is no need to make the externalization mandatory as the trading book leg of an eligible internal CVA hedge will be capitalized as part of trading book rules</p>

# Appendix

## Term Repo-Style Transactions – Bank A RWA Calculations

### ❖ Example Trade:

**1-month reverse repo on a 10y Govt bond, \$9.8mm notional lent, \$10mm market value of bond collateral received.**

**RST Market Risk:** IR01 = -\$82/bp, RW = 170bp, **FRTB IR Delta RWA = \$173.5k**

**RST Credit Risk:** Haircut = 2.83%, EAD = \$83k, RW = 40%, **RWA = \$33k.**

**Collateral Market Risk (as Long Bond):**

- IR01 = -\$8,047/bp, RW = 110bp, FRTB IR Delta RWA = \$11.1mm
- CR01 = -\$8,047/bp, RW = 50bp, FRTB CR Delta RWA = \$5mm
- DRC: FRTB DRC RWA as per collateral haircut = \$83k\*

**RST Credit Risk (as unsecured loan):** EAD = \$9.8mm, RW = 40%, **RWA = \$3.9mm**

Current Treatment as RST:  
Total RWA = **\$206.5k**

NPR Treatment as RST: Total RWA = **\$16.2mm\*\*** (RST treatment + Collateral in Market Risk)

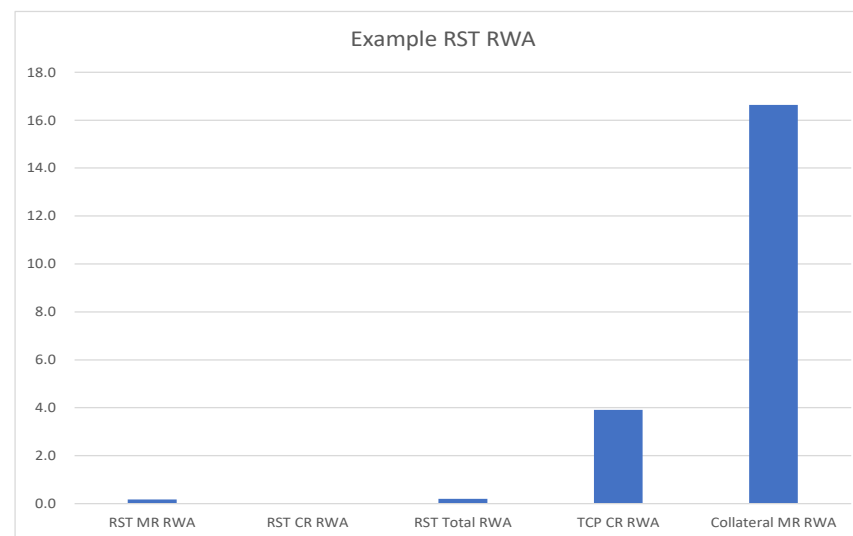
Current Treatment as Loan: Total RWA = **\$3.9mm**  
(No collateral recognition)

- With collateral risk factors included in FRTB MR, the total RWA of a RST is many times larger than an unsecured loan – which is misaligned with the economic risk.
- Additionally, it is not dependent on the amount lent and, in extremes, could produce a capital requirement far in excess of maximum possible loss (e.g., if \$1mm lent against \$10mm bond collateral at 10% LTV)

\*An alternative interpretation on how to include in DRC could be:

DRC: Exp = \$9.7mm, RW = 0.6%, FRTB DRC RWA = \$546.6k

\*\* Based on the alternative DRC calculation total RWA would be \$16.8mm



## Term Repo-Style Transactions – Bank B RWA Calculations

### ❖ Example Trade:

**A: 1-month repo on a 10y Govt bond, \$9.8mm notional borrowed, \$10mm market value of bond collateral lent.**

**B: Pre-existing Trading Book position in the 10y Govt Bond**

**RST Market Risk:** IR01 = \$82/bp, RW = 170bp, FRTB IR Delta RWA = \$173.5k

**RST Credit Risk:** Haircut = 2.83%, EAD = \$483k, RW = 40%, RWA = \$193k.

#### **Trading Book Long Bond Market Risk:**

- IR01 = -\$8,047/bp, RW = 110bp, FRTB IR Delta RWA = \$11.1mm
- CR01 = -\$8,047/bp, RW = 50bp, FRTB CR Delta RWA = \$5mm
- DRC: Exp = \$10mm, RW = 0.6%, FRTB DRC RWA = \$563k\*

#### **Collateral Market Risk (as Short Bond):**

- IR01 = \$8,047/bp, RW = 110bp, FRTB IR Delta RWA = \$11.1mm
- CR01 = \$8,047/bp, RW = 50bp, FRTB CR Delta RWA = \$5mm
- DRC: FRTB DRC RWA as per collateral haircut = \$483k\*\*

#### **Trading Book Long Bond + Collateral Posted Market Risk:**

- IR01 = \$0, RW = 110bp, FRTB IR Delta RWA = \$0
- CR01 = \$0, RW = 50bp, FRTB CR Delta RWA = \$0
- DRC: \$563 + \$483 = \$1.05mm\*\*\*

Current Treatment:

Total RWA = **\$17mm**

(RST + Trading Book Long Bond)

NPR Treatment:

Total RWA = **\$1.4mm\*\*\*\***

(RST + Trading Book Long Bond + Collateral in Market Risk)

- With collateral risk factors included in FRTB MR, the short risk sensitivities of the lent collateral (which has no P&L risk for the bank) incorrectly offset the real risk of the Trading Book bond position to materially understate to MR RWA.

\*An alternative interpretation on how to include in DRC could be:

DRC: Exp = \$9.7mm, RW = 0.6%, FRTB DRC RWA = \$546.6k

\*\*Based on alternative interpretation: DRC: Exp = -\$9.7mm, RW = 0.6%, FRTB DRC RWA = \$0k (given that it is considered a short)

\*\*\* Based on the alternative DRC calculation DRC RWA would be \$0mm given that short bond (collateral) and long bond offset

\*\*\*\* Based on the alternative DRC calculation total RWA would be \$367k