

Basel Committee on Banking Supervision Consultative Document

Fundamental Review of the Trading Book

Dated May 2012

The International Swaps and Derivatives Association, Inc.

The Global Financial Markets Association

And

The Institute of International Finance, Inc.

Further Response Covering

Standard Calibration of Models and Standard Rules

May 2013

1. Introduction

In this paper we would like to set out our thoughts on the proposals for the standard rules approaches proposed in BCBS 219. It continues our recent series of additional detailed feedback papers following our first response in September 2012.

In our September 2012 response to BCBS 219 we indicated that the partial risk factor approach may be more suitable for firms that do not use internal models while the full risk factor proposal is better aligned with infrastructures at banks with internal models. We also suggested that the existing standard rules approach should be considered an option for non-model firms. We are aware however that regulators were not envisaging a menu of standard rules approaches and indeed such choices may not assist with the notion of a standard benchmark. On reflection we feel that the ideas for standard rules set out by the TBG may be overly prescriptive and complex because they attempt to achieve too many goals.

Under current proposals we see several roles for standard rules and these create some conflicts in choice of approach which we feel may be better addressed by considering use of a standardized calibration of internal models for the purpose of benchmarking models and making cross firm comparisons. If Regulators are prepared to consider this concept, standard rules could remain much closer to current approaches which are simple for firms to apply and would be sufficiently conservative as a “beta-weighted” add-on as proposed in our last response¹.

Our understanding is that regulators wish standard rules to meet the following objectives:

1. A simple calculation of capital for firms without internal models. For this, existing standard rules are appropriate although some recalibration may be required in places. Otherwise, of the two proposals the partial risk factor approach is probably the preferred route for non-IM firms.
2. A conservative and realistic alternative to internal models based capital at both desk and firm level. It would seem reasonable and consistent that the same rules used in (1) are suitable for this. Note we have proposed that these rules, weighted by “beta”, be an add-on to the internal model. We think this creates the right incentives to improve internal models. Presumably there should be an option for a firm to pull the model completely at the desk level and move to standard rules with beta=1 (e.g. should model performance fail internal standards).
3. A benchmark against which to compare internal model metrics. We believe that standard rules will never be sufficiently risk sensitive to do the job unless they are also complex and hence not suitable for non-IM firms. Rather than use standard rules for this objective, we think a better approach is to require firms to apply their models to their own portfolios, and to hypothetical portfolios, but based on calibration standards prescribed by regulators (the calibration should be straightforward to implement). That is regulators might prescribe a standard look-back period, a standard liquidity horizon and such other standardization as regulators and industry identify as being causes of RWA variation across firms. We discuss below in more detail our recommendations for these standards. We expect such standards to evolve through time. Differences in model values due to variations from the standard calibration would provide a

¹ Further Response Covering Calibration of Alpha and Beta, March 28, 2013 - ISDA, GFMA and IIF response to Basel Committee on Banking Supervision (BCBS) Consultative Document on the Fundamental Review of the Trading Book (<http://www2.isda.org/attachment/NTQyOA==/FRTB%20Calibrating%20Alpha%20and%20Beta%20Final.pdf>)

useful tool for regulators when approving model applications. Capital benefits arising from internal models could be compared across firms by considering benefits against the standardized calibration. Such models would also aid the identification and classification of sources of RWA variation in hypothetical portfolio exercises.

While the Industry would be happy to engage further with the TBG on recalibration of the existing standard rules approach, or indeed on the design of a new simple standard rules approach, the focus of this proposal is on standardization of model calibration for benchmarking purposes (objective 3 above). Clearly this proposal dovetails well with the hypothetical portfolio exercises undertaken by Basel and also now by industry under the GARP Benchmark Portfolio Initiative (GBPI). Standardized models and benchmark portfolios should, we believe, provide the necessary tools to enable identification and understanding of variation of RWA estimates across firms. We see such standardization as an ongoing process that will benefit from experience and will evolve through time. The approach may also help to inform recalibration of standard rules from time to time.

2. The proposed framework for standard calibration of models

We think that the Industry should be able to calculate RWAs using their internal models both with internal calibration and a standard calibration. This standard calibration approach maintains the hedging and risk sensitivity benefits of internal models but allows cross firm comparisons notwithstanding the diversity of model approaches across firms. We believe this diversity is important to achieving high capital standards, model innovation, and to allow regulatory capital rules to adapt to changing market environments. In order to be achievable by as many firms as possible without becoming unduly onerous, the standardized calibration should appeal to the basic units of measurement used by firms. This does not mean the benchmark model is necessarily conservative or best practice, but it should be scalable and most importantly retains the risk sensitivity necessary to create a meaningful benchmark.

It is important to remain focused on model variation and not local regulatory variation in this exercise. Differences in regulatory requirements can be understood without benchmarking. We would not, for example, expect to analyse differences in multiplier regimes, regulatory add-ons, prescribed aggregation or “disallowed” diversification etc. but would focus on the core model calibrations at the discretion of firms. That is not to say that regulatory differences should not be made clear, but this is not the focus of our proposal which is on model differences. In a similar vein, we would not propose to duplicate effort by, for example, looking at both stressed VaR and current VaR. The former is simply the application of the VaR model to a stressed period and of course the choice of period, reflecting portfolio differences, may legitimately vary across firms. We therefore propose to focus on the core risk components: VaR/ES, IRC and CRM.

Finally, in pursuing standardization, as indicated above we expect to learn from experience. We propose to start with high level sources of variation identified in portfolio exercises conducted so far and to refine the identification and standardization of more granular calibration, for example detailed risk factor constructions, at later stages as residual variations across firms are analyzed. The process of increasing granularity should stop when sufficient variation across firms on benchmark portfolios is explained to the satisfaction of most stakeholders (firms, regulators, analysts, shareholders).

Some examples of sources of model variation that can be standardised:

VaR / Expected Shortfall:

Look-Back Period

We suggest all firms should be capable of using a 1-year look-back period. For historical simulation firms this should be straightforward, for Monte-Carlo firms then calibration to this period should be possible.

Volatility scaling

All firms should be able to run without volatility scaling (Filtering Historical Simulation), or other weighting schemes. That is the scenarios should have equal weight.

Liquidity Horizon

All firms should be able to calculate 1-day VaR, with a simple square root of time rule applied to generate the risk measure to the required horizon.

IRC / IDRC:

Liquidity Horizon

We suggest all firms use a 1-year liquidity horizon – in line with the capital horizon.

Correlation Matrix

A correlation matrix could also be prescribed which might be based on a simple single common systemic factor. At a second stage we may wish to distinguish for example between sovereign, corporate and asset backed securities.

We would suggest prescribed PDs and LGDs sourced from lookup tables. We would follow a rating transition type approach with agreed default and migration probabilities by rating and LGDs for various issuer types using a fixed matrix, and a mapping table. Credit parameters in IRC would likely not need to be reviewed very frequently at all, probably less than once a year.

CRM

The second Basel RWA benchmark exercise will provide insights for recommending calibration standardisation of this model.

Benchmarking

We would also suggest supplementing standardized model calibrations with other reduced-form or model free portfolio loss comparisons, e.g. using a “maximum loss” for these portfolios (corresponding either to “all default” or “all spreads to zero”), thus providing a very useful benchmark which is objectively calibrated.