



FEDERATION
BANCAIRE
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*Banking supervision
And Accounting issues Unit*

The Director

Paris, January 13rd 2012

French banking Federation comments on EBA Consultation Papers: CP 48 on Stressed Value at Risk (Stressed VaR) and CP 49 on Incremental Default and Migration Risk Charge (IRC).

Dear Mrs Vaillant,

The French Banking Federation (FBF) is the professional body representing the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 450 commercial and cooperative banks. FBF member banks have 40,000 permanent branches in France. They employ 400,000 people, and service 60 million clients.

The FBF welcomes the EBA publication of the two consultation papers with regard to the stressed value-at-risk ("SVaR") and Incremental Risk Charge ("IRC") implementation and supports the objective of ensuring a level playing field among institutions and enhancing convergence of supervisory practices across the EU.

The guidelines suggested address many issues that have been discussed at length between institutions and their national supervisor in the context of the SVaR and IRC models validation and are essential to ensure consistency across regulators and level playing field across institutions.

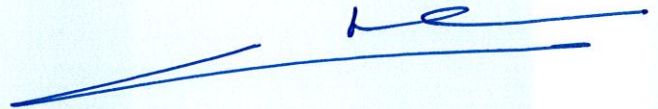
In this respect, we can only regret the very late timing of their publication all the more that their status (guidelines vs rules) is rather ambiguous and the extent to which institutions will be asked to re-model what has been agreed with their national supervisor not entirely clear. In any case, re-modelling is costly and burdensome especially taking into account the significant workload attached to the CRD IV implementation and we strongly encourage the EBA to publish its guidelines (even in draft format) more in advance of the implementation date of models in the future in general and in the context of the CRD IV in particular.

**Mrs Isabelle VAILLANT
European Banking Authority
Tower 42 (level 18)
25 Old Broad Street
London EC2N 1HQ
United Kingdom**

You will find in the annexes attached our details comments to the issues raised in both consultative documents

We thank you for the consideration of our remarks and remain at your disposal for any questions or additional information you might have.

Yours sincerely,

A handwritten signature in blue ink, consisting of a long horizontal line with a small loop at the end, and a shorter line above it that starts under the first part of the main line and ends under the loop.

Jean-Paul Caudal

Annex I: Detailed comments on CP 48: Stressed Value At Risk (Stressed VaR)

Page 11 : paragraph 6.8.

“Finally, institutions could consider the use of antithetic data when calibrating the Stressed VaR model. This would be particularly relevant between two regular reviews of the stressed period in the case of a dynamic portfolio.”

We ask for a clear definition of the concept of “dynamic portfolio” as the historical period must apply to the whole (IMM-approved) trading book.

Page 13 : paragraph 9.3

“In addition, monitoring of new trading book positions which materially reduce the Stressed VaR shall be implemented. The identification of positions entered with the main aim of significantly reducing the Stressed VaR shall then be used in the review of the stressed period.”

We do not think that the mere fact that positions have been taken to reduce (hedge) the Stressed VaR should automatically trigger a review of the Stressed VaR period. A review of the Stressed VaR period should be triggered only if there is a reason to believe that the risk structure of the portfolio has significantly changed or if a new period of greater stress has emerged. Overall, we believe this point is in contradiction with point § 15. 2 according to which *“where Stressed VaR outputs reveal particular vulnerability to a given set of circumstances, prompt steps should be taken to manage those risks appropriately”*.

We understand the EBA intention here is more to prevent “arbitrage” actions that are artificially reducing the SVaR and should be reformulated accordingly.

Consequently, we suggest the following wording:

*“In addition, monitoring of new trading book positions which materially reduce the Stressed VaR shall be implemented. ~~The identification of positions entered with the main aim of significantly reducing the Stressed VaR shall then be used in the review of the stressed period.~~ **Institutions shall ensure that those positions are not artificially reducing the Stressed VaR.**”*

Page 15 : paragraph 10. 3. (iii) c)

“An institution should be able to prove that, on the day of the week chosen for Stressed VaR calculation, its portfolio is representative of the portfolio held during the week and that the chosen portfolio does not lead to a systematical underestimation of the Stressed VaR numbers when computed weekly.”

It is necessary to clarify that this requirement should not be construed as a de facto requirement for a daily computation of the Stressed VaR. This requirement should be satisfied by other means or indicators. For example, proof that the VaR is not systematically higher on the day of the week chosen for Stressed VaR calculation should be considered as sufficient.

Page 16 : paragraph 10. 7

“Where sensitivities rather than full revaluation are used within a VaR model the institution concerned should demonstrate that this approach is still appropriate for Stressed VaR when higher order derivatives/convexity are factored in.”

Where sensitivities rather than full revaluation are used is where this VaR model has been approved. Therefore this approach, on a stressed period which already occurred, is already regarded as appropriate as it is authorized. We therefore propose to delete this section.

Page 16 : paragraph 10. 9

“In terms of calibration to market data, the process of “de-meaning” is not considered necessary for Stressed VaR. If there is a significant drift in market data, the use of antithetic data is preferable to “de-meaning”.”

We believe the use of antithetic data should remain an example among others in the list of possible adaptations of the VaR methodology to the Stressed VaR calibration (consistently with the BCBS FAQs for Basel 2.5) and become neither a “compulsory” nor a “preferred” method. One obvious reason for that is the fact that using antithetic data is relevant for historical VaR but much less so for Monte Carlo VaR where it could distort the distribution.

We propose instead the following wording:

“In terms of calibration to market data, the process of “de-meaning” is not considered necessary for Stressed VaR. If there is a significant drift in market data ~~the use of antithetic data is preferable to “de-meaning”~~ institutions could consider, when appropriate, the use of antithetic data instead of “de-meaning”.”

Page 19 : paragraph 15. 1

“The Stressed VaR model should be subject to a use test through use of Stressed VaR output in risk management decisions (e.g. limit setting, reporting and escalation procedures, etc.).”

We would like to clarify that the examples given in this paragraph (*limit setting, reporting and escalation procedures, etc*) are examples only and that there are different ways to satisfy the use test. Overall, given that the Stressed VaR is a kind of new, non-conventional, countercyclical risk measure, we believe a wide flexibility should be kept in deciding on how to use it, acknowledging that, as a new (and important) capital charge, it is at minima expected to be allocated and monitored at different aggregation levels and reviewed periodically by senior management.

Page 19 : paragraph 15. 2.

“Stressed VaR should also be used to periodically validate the impact of current VaR modelling choices. Where Stressed VaR outputs reveal particular vulnerability to a given set of circumstances, prompt steps should be taken to manage those risks appropriately.”

We believe the use of the Stressed VaR as a tool to validate the current VaR modelling choices is very questionable. This would not be very objective and cause us to “look over our shoulder” when we should rather be looking forward when improving VaR modelling.

Annex II: Detailed comments on CP 49: Incremental Default and Migration Risk Charge

Page 11 : paragraph 4. 3

“Positions in defaulted debt held in the trading book shall in principle be included. [...] The risk of price changes of defaulted debt, as driven by uncertain recovery marks or an expectation about ultimate recovery shall be capitalised in all cases, ideally using the IRC model.”

It is important to take positions defaulted debts into account for the calculation of the IRC where they are part of a specific activity (such as trading of distressed debt). However, when it is in the context of credit events,, banks should be authorized to exclude from the calculation of the IRC these positions which are temporarily held in the trading book, but will eventually be excluded and capitalized according to other applicable standards.

Except for institutions that actively trade defaulted bonds, this risk is of secondary order as defaulted bonds represent only a very small fraction of the overall portfolio.

We would suggest adding to this paragraph that this guideline only applies if material:

*« Positions in defaulted debt held in the trading book shall in principle be included **where material**. [...] The risk of price changes of defaulted debt, as driven by uncertain recovery marks or an expectation about ultimate recovery, shall be capitalised in all cases, ideally using the IRC model. »*

Page 12 : paragraph 7. 1

“Where IRC is calculated on a stand-alone basis [...]This means that positions in debt issued by subsidiaries, parent or other associate companies that are not consolidated by the group must be considered as defaultable and subject to migration risk.

The example shall not be limited to the case of consolidation of accounts but should also apply in case of consolidated supervision. We suggest the following wording:

*“Where IRC is calculated on a stand-alone basis [...]This means that positions in debt issued by subsidiaries, parent or other associate companies that are not consolidated by the group **or are not included within the scope of consolidated supervision**, must be considered as defaultable and subject to migration risk.*

Page 13 : paragraph 7. 3.

“Long positions in the institutions own debt may arise from trading or market-making activity in its own bonds. These positions have to be included within the scope of the IRC model but only migration risk shall be taken into account.”

It should be specified that only positions that give rise to a net profit or loss shall be included, i.e. whenever the P&L arising from those positions is neutralized at the consolidated level, they shall not be included.

Page 17 : paragraph 17.2 and 17.3

We propose to replace “can” with “may”:

*“2. Separate transition matrices ~~can~~ **may** be applied for specific groups of issuers and specific geographical areas. [...]. It is expected that institutions shall develop one (or more when relevant data is available) transition matrix that is specific to sovereign obligors.”*

*“3. When default is modelled as an absorbing state, transition matrices shall be adjusted to ensure that this absorbing state does not conflict with internal PD estimates. Any such adjustments shall be documented, and the impact of the specified adjustment shall be included as part of the documentation. 4. Similarly, transition matrices where “NR” or another column is an absorbing state for withdrawn ratings or non-rated exposures ~~can~~ **may** be adjusted. The conditions for such an adjustment are identical to the ones highlighted in paragraph 3 above.”*

Page 18 : paragraph 18. 2.

“Alternatively to what is described in paragraph 1 above, institutions are allowed to choose to consistently use a one-year constant position assumption, which implies not adopting liquidity horizons, but applying to all IRC positions an instantaneous shock over the one-year capital horizon (referred to as “one-year constant position assumption”).”

The EBA guideline “requires that institutions shall rebalance or roll-over positions at the end of each liquidity horizon to new positions such as to ensure the same initial level of risk as at the start of the liquidity horizon” (cf § 18. 1.) It would be logical to apply this rule to the conservative assumption of a one year liquidity period. One should note that nothing in this text prevents an institution from applying the rule for a Liquidity horizon just below 12 months (for example 11 months) which de facto allows for the ageing of the portfolio.

The hypothesis that an institution will periodically roll-over its positions may only be valid if the activity is on-going. Due to the 2008 crisis, several institutions have stopped some of their activities, in particular in credit derivatives. In such cases, the hypothesis that the institution will periodically roll-over its positions is not valid and the portfolio will age naturally (sometimes even more quickly as the institutions are managing the book towards extinction). In the cases where portfolios are run into extinction, national regulators should allow the institution to assume the ageing of the book (therefore applying rule (18. 1.) with a 1 year Liquidity horizon). This remark is even truer for the Comprehensive Risk Measurement since many institutions have stopped commercial activities in their Correlation books, managing them in run-off mode.

Page 18 : paragraph 18. 4.

“Over the one-year capital horizon or when replacing original positions with risk-equivalent positions from one liquidity horizon to another, institutions only need to model unexpected loss within the IRC model.”

The intention behind this requirement seems to be to take into account the theta and risk premium effects (indirectly) but this is not fully clear. In addition, modelling only the unexpected loss within the IRC model is not always conservative as it depends on the overall portfolio direction (short protection and long risk premium or vice versa). We believe the guideline should encourage institutions to take into account the theta effect in their models and not prescribe the modelling of UL only as the only authorised way to achieve it.

Page 19 : paragraph 18. 5

“Modelling a constant level of risk over the one-year capital horizon may be achieved, for example, on the basis of the approach outlined hereafter. [...]). As a result, measurement of losses within IRC does not take into account the timing of each migration or default event, and the P&L is computed as of today.”

It should be made clear that, alternatively, the institution may choose to model the ageing of its positions.

Page 19 : paragraph 19. 3

“In order to reflect basis risk appropriately, valuation for the purposes of the IRC for related positions (like, for example, bonds and CDSs on the same obligor) must be differentiated. Thus, net long and net short positions that reference similar - but not identical - underlying assets should not result in an IRC measure equal to zero.”

Except for institutions that have very large basis positions, this risk is of secondary order as bonds and CDSs move largely together. We would suggest adding to this paragraph that this guideline only applies if material.

Page 19 : paragraph 19.4

« Institutions shall reflect the impact within the liquidity horizon of maturity mismatches between long and short positions (for example if a CDS matures before the underlying bond and the default happens after the CDS maturity), if the resulting risks are material. Therefore, an institution should be able to compute the P&L taking into account the impact of potential maturity mismatches between long and short positions. An institution shall at a minimum be able to prove that the above mentioned risk is not a material risk or will have to model the risk accordingly.”

When an institution decides on an annual liquidity horizon for all its positions, the notion of “maturity mismatches” is neither coherent with the notion of “constant position assumption” mentioned in §18.2 page 18, nor with the principles of “instantaneous shocks” and “no ageing of positions” detailed in §18.2 page 18 and §18.5 page 19.

To be consistent with the overall text, we suggest deleting this paragraph.

Page 25 : paragraph 26

“1. An institution must document how the IRC process is reported internally, its resulting risk-measurement judgements and the role these judgements play in the (risk) management of the institution.

2. The procedures that, given the judgement of the IRC, lead to potential appropriate corrective action shall be in place and well embedded within risk management.

3. A comparison of the ways internal market risk models outputs are reported, judged, audited and used internally by specific departments within the institution is considered a helpful way to clarify the use test.”

The proposed wording does not seem appropriate for the IRC which is primarily an additional capital charge and which has not been designed as an operational risk measure. We subsequently propose to replace the concept of “judgment” with the one of “analysis”.

*"1. An institution must document how the IRC process is reported internally, **its resulting analysis and the role these analysis play** in the (risk) management of the institution.*

2. ~~The procedures that, given the judgement of the IRC, lead to potential appropriate corrective action shall be in place and well embedded within risk management.~~

2. A comparison of the ways internal market risk models outputs are reported, judged, audited and used internally by specific departments within the institution is considered a helpful way to clarify the use test.

Page 26 : paragraph 29. 2

"The institution shall be able to prove that, on the day of the week chosen for IRC calculation, its portfolio is representative of the portfolio held during the week and that the chosen portfolio does not lead to a systematic underestimation of the IRC numbers when computed weekly."

We would like the EBA to clarify that this requirement should not be construed as a de facto requirement for a daily computation of the IRC. This requirement should be satisfied by other means or indicators.