FINANSTILSYNET
THE FINANCIAL SUPERVISORY AUTHORITY OF NORWAY

Basel Committee on Banking Supervision
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Comments on the Basel Committee on Banking Supervision's consultative document: Fundamental review of the trading book

Joint comments from Norges Bank and Finanstilsynet
Norges Bank and Finanstilsynet welcome the initiative taken by the Basel Committee on Banking Supervision to comprehensively evaluate the overall design of the market risk regulatory regime and to propose measures to strengthen capital standards for market risk.

Norwegian banks are primarily engaged in traditional lending activities and risk in the trading book has so far not been a major contributor to capital requirements for Norwegian banks. Norwegian banks primarily use the standardised approach for market risk. We support the proposed measures to make the standardised approach more risk-sensitive. We underline, however, that when making the detailed set of rules it is important to strike a reasonable balance between risk sensitivity and the complexity of the regulatory rules. Of the principles guiding the design of the standardised approach listed on page 41 in the consultation document, we emphasise as important the principles of "simplicity, transparency and consistency" and the principle of "limited model reliance". Based on the consultation document's description of the partial risk factor approach and the fuller approach, we support the partial risk factor approach as the basis for the revised standardised approach since this approach seems to be most in line with these two principles.

At this stage, the effects of the proposals on capital requirements for Norwegian banks are not clear. We therefore welcome the Committee's plan to perform a quantitative evaluation (the quantitative impact study) when the detailed set of proposals has been made.

Below, we comment on selected proposals in the consultation document.

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Reassessment of the boundary
Norges Bank and Finanstilsynet support the initiative to improve the definition of the regulatory boundary between the trading book and the banking book. Of the two alternative boundary definitions, we prefer the trading evidence-based boundary. In our opinion, this approach is preferable to the valuation-based approach because the implementation will be more consistent across jurisdictions since the trading evidence-based boundary is independent of accounting regimes. In addition, we support this approach since it will be less burdensome for banks and supervisors to implement.

A revised trading evidence-based boundary may result in more fair-valued positions placed in the banking book than under the current regulation. The Committee points out, c.f. footnote 12 on page 13 in the consultation document, the importance of capturing market risk of positions in the banking book. We therefore welcome the Committee's intention to do further work on a possible capital requirement for interest rate risk in the banking book.

Use of expected shortfall as a risk measure
We support the Committee's proposal to use expected shortfall (ES) as a risk measure. When aggregating risks to a total risk measure, the use of ES has several desirable properties over VaR, essentially because ES, compared to VaR, also considers the whole tail of a distribution and not just a fixed percentile.

Liquidity risk
The proposal contains suggestions for a comprehensive incorporation of liquidity risk in the capital requirement for market risk. We broadly agree to the suggested methods for incorporating exogenous liquidity risk (caused by general market conditions). Assets will be allocated into liquidity horizons in order to take account of the time it takes to exit from a position, and stress tests will be used to account for sudden increases in illiquidity premiums influencing market prices.

We support the proposal that endogenous liquidity risk (determined by characteristics of the bank's portfolio) should be reflected in the capital requirement. Such a rule will discourage banks from holding too large or too concentrated exposures relative to the market.

The flexibility of the models-based approach makes it possible to include the different types of liquidity risk. While liquidity horizons will be used when calibrating the standardised approach (p. 45), it is less clear how the different types of liquidity risk will be factored into the standardised capital requirement. We await a more elaborate exposition of how liquidity risk will be captured under the standardised approach in the more detailed proposal to come.

Yours sincerely,

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