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APRA

To All Authorised Deposit-taking Institutions (ADIs)

CONSULTATION ON ADJUSTMENTS TO THE BASEL II ENHANCEMENTS PACKAGE

On 18 June 2010, the Basel Committee on Banking Supervision (BCBS) announced certain adjustments to the document *Revisions to the Basel II market risk framework* (the market risk revisions)[1]. The BCBS also agreed to a coordinated start-date of not later than 31 December 2011 for all elements of the BCBS trading book package released in July 2009[2]. This package consists of the documents *Revisions to the Basel II market risk framework* and *Guidelines for computing capital for incremental risk in the trading book*.

To facilitate consistency, the BCBS also agreed to permit flexibility in implementing the *Revisions to Pillar 1* of the July 2009 document *Enhancements to the Basel II framework*[3] (the Basel II enhancements) at the same time as the trading book reforms.

On 21 June 2010, APRA wrote to ADIs[4] advising them of the BCBS adjustments and of APRA's intention to follow the BCBS's delayed timetable for implementation of the changes to all aspects of the Basel II enhancements package, and to the other provisions included in APRA's December 2009 Discussion Paper *Enhancements to the Basel II Framework in Australia*[5]*.* APRA also advised that it would consult with industry on the adjustments to the market risk framework announced by the BCBS on 18 June 2010. The purpose of this letter is to begin this consultation.

Specifically, APRA is seeking industry comments on the two main BCBS adjustments announced:

(1) The capital charge for non-correlation trading securitisation positions

The proposal is that for a transition period of two years following the implementation of the market risk revisions, the capital charges for non-correlation trading securitisation positions be based on the larger of the capital charges for net long and net short positions.

(2) Floor for correlation trading securitisation positions

In line with the BCBS's announcement in paragraph 9 of the July 2009 market risk revisions that it would evaluate a floor for the interest rate specific risk charge for correlation trading securitisation positions, the proposal is to set this floor at eight per cent of the standardised measurement method.

The BCBS press release of 18 June 2010 announcing these adjustments is set out in Appendix A.

Written submissions on these adjustments should be emailed by 5 November 2010 to:

basel2enhancements@apra.gov.au

[1] http://www.bis.org/press/p100618.htm
[2] http://www.bis.org/press/p090713.htm
[3] http://www.bis.org/publ/bcbs157.htm
[4] http://www.apra.gov.au/ADI/upload/Final-Letter-re-BCBS-Enhancements-to-Basel-II-capital-framework-June-2010-2.pdf
[5] http://www.apra.gov.au/Policy/Proposed-Basel-II-Enhancements-2009.cfm

Subject to consultation on these market risk revisions, APRA expects that the final prudential standards, prudential practice guides, reporting standards and reporting forms arising from the adoption of the Basel II enhancements and other changes APRA proposed in its Discussion Paper and its May 2010 consultations on reporting requirements[6], will be released in early 2011 and are intended to become effective from 1 January 2012.

The above matters are proceeding independently from the capital and liquidity reforms currently under development by the Basel Committee, and expected to be announced in December 2010. APRA's intent is to conduct extensive consultations on these larger reform matters during 2011.

Yours sincerely,

Charles Littrell
Executive General Manager
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[6] http://www.apra.gov.au/Policy/Enhancements-to-the-Basel-II-framework-in-Australia-May-2010.cfm

Appendix A

Adjustments to the Basel II market risk framework announced by the Basel Committee

18 June 2010

The Basel Committee on Banking Supervision has agreed on certain adjustments to the document *Revisions to the Basel II market risk framework* (the market risk revisions). This revised market risk framework was released in July 2009 and covered the following areas:

1. Banks using internal models in the trading book must calculate a stressed value-at-risk based on historical data from a continuous 12-month period of significant financial stress;
2. Banks using internal specific risk models in the trading book must calculate an incremental risk capital charge (IRC) for credit sensitive positions which captures default and migration risk at a longer liquidity horizon;
3. Securitisation positions held in the trading book will be subject to the Basel II securitisation charges, similar to securitisation positions held in the banking book; and
4. So-called correlation trading books are exempted from the full treatment for securitisation positions, qualifying either for a revised standardised charge or a capital charge based on a comprehensive risk measure.

The adjustments announced today relate to elements 3 and 4 above:

- The Committee has re-confirmed the capital charge for non-correlation trading securitisation positions, i.e. to base it on the sum of the capital charges for net long and net short positions. However, for a transition period of two years following the implementation of the market risk revisions, the charges may be based on the larger of the capital charges for net long and net short positions. During this period of transition, there is a need to ensure that there is not undue recognition of hedging between economically unrelated positions.

- In line with its announcement in paragraph 9 of the July 2009 market risk revisions that it would evaluate a floor for the correlation trading securitisation positions, the Committee agreed to set this floor at 8% of the standardised measurement method.

Furthermore, the Committee agreed to a coordinated start-date of not later than 31 December 2011 for all elements of the July 2009 trading book package. This consists of the *Revisions to the Basel II market risk framework* and the *Guidelines for computing capital for incremental risk in the trading book*. This coordinated start date will provide supervisors with additional flexibility that will permit more robust implementation and review of changes to market risk models. To facilitate consistency, the Committee also agreed to permit the flexibility to implement the *Revisions to Pillar 1* of the document *Enhancements to the Basel II framework* (released in July 2009) at the same time as the trading book reforms.

As a result of these revisions, market risk capital requirements will increase by an estimated average of three to four times for large internationally active banks.

The changes to the respective documents are attached in the Annex to this press release.

http://www.bis.org/press/p100618/annex.pdf

Annex

Changes to the Revisions to the Basel II market risk framework

1. Paragraph 709(ii) of the Basel II Framework as amended by the *Revisions to the Basel II market risk framework* will be changed as follows, and a new paragraph 709(ii-1-) will be introduced. New wording is underlined.

> 709(ii). The minimum capital requirement is expressed in terms of two separately calculated charges, one applying to the "specific risk" of each security, whether it is a short or a long position, and the other to the interest rate risk in the portfolio (termed "general market risk") where long and short positions in different securities or instruments can be offset. The bank must, however, determine the specific risk capital charge for the correlation trading portfolio as follows: The bank computes (i) the total specific risk capital charges that would apply just to the net long positions from the net long correlation trading exposures combined, and (ii) the total specific risk capital charges that would apply just to the net short positions from the net short correlation trading exposures combined. The larger of these total amounts is then the specific risk capital charge for the correlation trading portfolio.
>
> 709(ii-1-). During a transitional period until 31 December 2014, the bank may exclude positions in securitisation instruments which are not included in the correlation trading portfolio from the calculation according to paragraph 709(ii) and determine the specific risk capital charge as follows: The bank computes (i) the total specific risk capital charge that would apply just to the net long positions in securitisation instruments in the trading book, and (ii) the total specific risk capital charge that would apply just to the net short positions in securitisation instruments in the trading book. The larger of these total amounts is then the specific risk capital charge for the securitisation positions in the trading book. This calculation must be undertaken separately from the calculation for the correlation trading portfolio.

2. Paragraph 712(iii) of the Basel II framework which was introduced by the *Revisions to the Basel II market risk framework* will be corrected as follows. New wording is underlined, deleted wording is struck out.

> 712(iii). The specific risk of securitisation positions as defined in paragraphs 538 to 542 which are held in the trading book is to be calculated according to the method used for such positions in the banking book unless specified otherwise below. To that effect, the risk weight has to be calculated as specified below and applied to the net positions in securitisation instruments in the trading book. The total specific risk capital charge for n-th-to-default credit derivatives~~the correlation trading portfolio~~ is to be computed according to paragraph 718, and the total specific risk capital charge for securitisation exposures is to be computed according to paragraph 709(ii).

3. After paragraph 712(vii) of the Basel II framework, the following heading and paragraph will be introduced.

> *Limitation of the specific risk capital charge to the maximum possible loss*
>
> 712(viii). Banks may limit the capital charge for an individual position in a credit derivative or securitisation instrument to the maximum possible loss. For a short risk position this limit could be calculated as a change in value due to the underlying names immediately becoming default risk-free. For a long risk position, the maximum possible loss could be calculated as the change in value in the event that all the underlying names were to default with zero recoveries. The maximum possible loss must be calculated for each individual position.

4. Paragraph 718(xcv) of the Basel II framework as amended by the *Revisions to the Basel II market risk framework* will be changed as follows. New wording is underlined, deleted wording is struck out.

> 718(xcv). Subject to supervisory approval, a bank may incorporate its correlation trading portfolio in an internally developed approach that adequately captures not only incremental default and migration risks, but all price risks ("comprehensive risk measure"). The value of such products is subject in particular to the following risks which must be adequately captured:
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> - the cumulative risk arising from multiple defaults, including the ordering of defaults, in tranched products;
> - credit spread risk, including the gamma and cross-gamma effects;
> - volatility of implied correlations, including the cross effect between spreads and correlations;
> - basis risk, including both
>   - the basis between the spread of an index and those of its constituent single names; and
>   - the basis between the implied correlation of an index and that of bespoke portfolios;
> - recovery rate volatility, as it relates to the propensity for recovery rates to affect tranche prices; and
> - to the extent the comprehensive risk measure incorporates benefits from dynamic hedging, the risk of hedge slippage and the potential costs of rebalancing such hedges.
>
> The approach must meet all of the requirements specified in paragraphs 718(xciii), 718(xcvi) and 718(xcvii). This exception only applies to banks that are active in buying and selling these products. For the exposures that the bank does incorporate in this internally developed approach, the bank will ~~not~~ be required to subject them to <u>a capital charge equal to </u>the <u>higher of the capital charge according to this internally developed approach and 8% of the </u>capital charge for specific risk according to the standardised measurement method<u>. It will not be required to subject these exposures to</u> ~~or~~ the treatment according to paragraph 718(xciii)~~, as applicable~~. It must, however, incorporate them in both the value-at-risk and stressed value-at-risk measures.

5. Paragraph 13 of the *Revisions to the Basel II market risk framework* will be changed as follows.

> Banks are expected to comply with the revised requirements by no later than 31 December 2011. This also applies to portfolios and products for which a bank has already received or applied for approval for using internal models for the calculation of market risk capital or specific risk model recognition before the implementation of these changes. National supervisory agencies should use the time between the announcement of this amendment and the implementation date to thoroughly validate and approve banks' internal models for calculating the incremental and comprehensive risk capital charges.

6. The first paragraph of the *Enhancements to the Basel II framework*, released in July 2009 will be changed as follows.

> The proposals for enhancing the Basel II framework in the area of securitisations and more specifically for dealing with resecuritisations have been finalised. Banks are expected to comply with the revised requirements by 31 December 2011.