

## A. Introduction

Deutsche Börse Group (DBG) welcomes the opportunity to comment on BCBS consultative document “Fundamental review of the trading book: A revised market risk framework” issued in October 2013.

DBG is operating in the area of financial markets along the complete chain of trading, clearing, settlement and custody for securities, derivatives and other financial instruments and as such mainly active with regulated Financial Market Infrastructure providers.

Among others, Clearstream Banking S.A., Luxembourg and Clearstream Banking AG, Frankfurt/Main, who act as (I)CSD<sup>1</sup> as well as Eurex Clearing AG as the leading European Central Counterparty (CCP), are classified as credit institutions and are therefore within the scope of the European Capital Requirements Directive (CRD) and Capital Requirements Regulation (CRR) which transposed i.a. the Basel III rules into European law. Clearstream subgroup is supervised on a consolidated level as a financial holding group.

However, all our group entities in scope of CRD/CRR and therefore Basel III rules are offering limited banking activities ancillary to their function as Financial Market Infrastructure (FMI). In order to operate as a Financial Market Infrastructure and in line with the dedicated regulatory framework (e.g. CPSS-IOSCO principles for financial market infrastructures as of April 2012) as well as generally recognised business practices, the business model of our group entities is risk averse, allows loan business only in connection with clearing, settlement and custody activities for very short durations (and in general on a collateralised basis without intended financial leverage). None of our entities are performing proprietary trading in order to gain trading profits, they are purchasing securities only for intended long-term investments and are entering into a few derivatives positions for limited hedging purposes only.

Cash received out of the functions of our companies is based on the sole discretion of the clients<sup>2</sup>. It is invested with low credit risk and to a large degree without maturity transformation. For the CCP business collateral taken is the consequence of the

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<sup>1</sup> (International) Central Securities Depository

<sup>2</sup> Margin/collateral requirements may be fulfilled by either cash or securities to the discretion of the client.

general political preference for CCP cleared business especially for financial derivatives. Those collaterals and our capital are invested to a large extent into sovereign debt instruments with highest liquidity and credit quality. These instruments are held with the intention to hold them until they mature. Only instruments listed on an exchange provide the required level of liquidity in order to generate funds quickly if needed. As a consequence of proper organisational set-up we clearly distinguish between trading activities and related controls and the management of any investments is performed via a trading desk.

Our response to the consultation is reflecting on the proper definition of the trading book and its' boundary to cover businesses like ours, which are not engaged in any dedicated business with trading intent or a dedicated proprietary trading activity, however undertake all measures to fulfil the increasing number of banking regulations (sufficient capitalisation, capital adequacy, short- and midterm liquidity ratios, appropriate maturity matching of assets and liabilities, sufficient diversified investments to avoid concentration risk and sound and proper organisational set-up). We follow the strict requirements for good corporate governance defined via the “Principles for enhancing corporate governance” (BCBS #176) and the clear segregation of duties as requested by principle 6 of “Framework for Internal control systems in banking organisations” (BCBS #40). In addition we comply with additional EU- and national rules in that context. As a consequence conducting of Foreign Exchange-, Money Market-, Interest Rate transactions, etc. are performed via a dedicated trading desk with segregated control functions.

The document at hand contains a management summary in part B, specific comments in part C and a conclusion in part D.

## **B. Management Summary**

We can follow the intention of the Basel Committee to enlarge the capital requirements for market risks as the current framework seems to have shortcomings in the coverage of these risks. The decision to increase capital requirements for market risks should be derived on possible future price deviations and the correspondent threat of losses. Contrary to that the revised rules create a variety of effects which contradict in our view the aim of the overall regulatory framework.

The revised market risk framework is especially redefining the trading book / banking book boundary. In the currently applied framework the intention of a trade to gain short term profits leads to an assignment to the trading book in case certain criteria are met. Instruments not held to gain a short term price deviation are in general assigned to the banking book.

The revised framework is more focused on characteristics of a financial instrument whether it should be assigned to the banking book or the trading book. In addition the isolated fact that investments are acquired via a trading desk already leads to a trading book assignment. The pure derivation of the trading book allocation from the kind of investment as proposed by the Committee in our view leads to quite some strange effects like:

- For equity investments in funds one of the criteria for the allocation to the trading book is the fact whether a look-through in a fund is possible or not. In case the look-through is possible the investment must be assigned to the trading book and therefore higher capital requirements are associated compared to an investment into an equity investment in a fund where no look-through is possible. Such a conduct is a clear incentive for in-transparency.
- Similarly direct investments in equity are allocated to the trading book in case they are listed equity. The mere differentiation on the listing here is making a more liquid investment (can be sold via the exchange) being in scope of more stringent requirements whereas non-listed equity with possible huge inherent risks are treated with less stringent requirements.

The intended enlargement of the trading book scope (i.e. the movement of the boundary between trading- and banking book towards the trading side) does not per se provide major benefits such as increasing the resilience of credit institutions (be-

side others). On the other hand a variety of credit institutions (such as the Deutsche Börse Group entities in scope) are exposed to higher operational efforts (and costs) and additional capital requirements from a framework that actually should cover risks these institutions do not even have. Especially credit institutions which are performing only a very limited scope of services (special purpose banks like our group companies) and are due to missing trading intent not facing material market risks will suffer from such a revised framework as it is almost unavoidable to invest in some financial instruments<sup>3</sup> which must be assigned to the trading book under the revised framework.

In this context we clearly reject a variety of aspects of the revised boundary of the banking book and the trading book in the proposed framework:

- Inclusion of any listed equities to the trading book regardless of investment intent (even long term, strategic investments without any trading intent); This is even worsen by explicitly excluding unlisted equities (even if short term investments are targeted at purchase);
- Allocation of equity investments in funds to the trading book only where look-through is possible, while investment in funds without the possibility of look-through are allocated to the banking book;
- General ignorance of the intention of certain trades;
- Allocation of any deal executed via a dedicated trading desk to the trading book.<sup>4</sup> **(Due to proper governance arrangements and in order to fulfil LCR this will introduce a trading book to any bank!)**

Further details see argumentation in part C.

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<sup>3</sup> E.g. in the context of the needed liquid assets for LCR purposes.

<sup>4</sup> A trading desk is most likely also needed in order to liquidate collateral received in case of a defaulting loan and in the context of recovery plans and demonstration of liquid assets to test liquidity ongoing to some extend via sales or similar transactions.

### C. Specific comments

We agree to the general criteria of covered instruments as listed in paragraph 4 of the revised market risk framework. In addition paragraph 11 defines general presumptions for specific kinds of instruments to be included in the trading book in any case. From our perspective some of the instruments listed in paragraph 11 shouldn't be included as a general rule. This is in particular true when taking the rules of paragraph 13 into account. Explicitly equity investment in a fund, listed equity and any option seems to be items for further clarification. In the following we describe several issues in more detail:

- With regards to equity investments in a fund (taken also the explicit exclusion of illiquid funds into account), the differentiation by the possibility to look through in our mind is not a risk sensitive approach. While we agree that measurement of risks for illiquid funds or funds without the possibility of look-through is more difficult we in contrast value such investments as being more risky or at least of the same level of risk and this should be reflected at least with same operational- and capital requirements;
- The generic exclusion from the trading book of un-listed equities and equity investments in a fund without look-through possibilities, regardless of even possibly proven trading intent also seems not appropriate. We therefore at least request to take out those two categories in paragraph 13;
- The uneven treatment of equity investment in funds without look-through possibilities (explicitly excluded in paragraph 13) with other investments in funds without look-through possibilities (classified based on the criteria as listed in paragraph 4) also is not acceptable;
- In this context we in addition ask the Committee to clarify what is meant by “equity” investment in a fund and what look-through comprises of. In case of the equity investment we understand it is targeted for investment in funds with underlying investments in (listed or un-listed) equities.<sup>5</sup> Related to the look-through approach, we wonder if only effective look-through is targeted for or

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<sup>5</sup> This brings the additional complexity that direct investment in unlisted equities is classified in the banking book while indirect investments via a fund with look-through possibilities contrary to that would mandatory classify for the trading book.

also a mandate-based approach would be covered. If both categories are included, we wonder how a credit institution with good risk management practices could invest in such vehicle at all as the institution would not know where it invests in. If only the effective look-through would be taken into account “cherry picking” would be made possible;

- Investments in listed equities are in general more liquid than those in non-listed equities. Therefore rules for operational and capital requirements for investments in listed equities should not per-se be more stringent than related to non-listed ones. In addition, any long-term investment (e.g. a [substantial] share in a listed company to secure long-term business interest) should not be categorised to the trading book;
- Further the fact that equity investments in listed shares are per-se qualifying as a covered instrument may shift business from regulated markets (exchange traded equities) to unregulated markets (not exchange traded equities). This is against the political will of regulators all over the world. Unregulated financial products are seen as a possible threat for the stability and integrity of the financial markets and consumer protection. In footnote 21 it is mentioned that several exemptions will be considered for the mandatory inclusion of listed equities to the trading book. We kindly ask the Committee to refine the approach in line with our concerns described above and take into account our comment on pension investments netted for accounting (and regulatory) purposes below;
- Instruments entered into for hedging purposes should not be categorised as trading book regardless of underlying business. Therefore the mandatory allocation of options to the trading book without acknowledging aspects of hedging banking book positions is rejected. Moreover, we cannot agree to only categorise options in that regard while ignoring other types of derivatives (e.g. futures). As such, only outright derivatives i.e. without hedging intent may be allocated to the trading book per-se;
- As a general rule the supervisory measures follow the accounting standard. Any asset allocated to pension obligations without any access of the reporting institution which is offset against pension and similar liabilities according to the accounting standard (e.g. IAS 19) should per-se not be allocated to the

trading book. The resulting net pension obligation or net pension asset should be treated according to the general rules for the banking book or under dedicated capital treatment, regardless of the investments. We cannot agree to deviate from the general rule to follow accounting standard in this case. In particular, a different approach would be in conflict to the treatment of such positions for equity purposes. Any net pension asset is deducted from the capital base<sup>6</sup>;

Beside our concerns to allocate certain instruments to the trading book per-se without consideration of the related trading intent we also oppose the allocation of transactions to the trading book for the only reason that these transactions are performed via a trading desk, as defined in paragraph 9. The term “trading desk” is defined in paragraph 21 to 23. In paragraph 21 it is described that a trading desk is given in case there is a group of traders that follow a well defined business strategy operating within a clear risk management structure. In paragraph 23 the “key attributes” of a trading desk are described (e.g. compensation of traders is linked to pre-established objectives).

Various other regulatory regimes<sup>7</sup> demand a proper management and especially risk management of investments and certain transactions like money market placement, purchases / sales of securities of FX positions, liquidity management, hedging, etc.. In addition, also general principles for proper remuneration are valid regardless of trading activities. Such requirements exist on various level (e.g. BCBS #194 “Range of Methodologies for Risk and Performance Alignment of Remuneration”) and require inter alia (a) clear targets / objectives, (b) an appropriate portion of variable remuneration linked to the pre-established targets / objective and (c) appropriate measures to disincentive excessive risks.

The “key attributes” as described in paragraph 23 are only defining general rules which have to be applied within proper organisation in order to execute proper liquidity and risk management. They are not linked to trading intent, trading success, or

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<sup>6</sup> See paragraph 76 of the Basel III framework.

<sup>7</sup> See for example “Principles for enhancing corporate governance” (BCBS #176) and the “Framework for Internal control systems in banking organisations” (BCBS #40) (especially principle 6)

any dedicated market risk. As such, they do not allocate the trading desk toward the trading book as any banking book trading needs to fulfil exactly those criteria.

It is not acceptable that compliance with other regulations and the adequate performance of financial risk management results automatically in the requirement to allocate positions to the trading book. In this case every institution in line with these regulatory regimes would be covered by the trading book rules. In our mind it is more than obvious that the decision whether a financial instrument must be included in the trading book or not cannot be based on such criteria as this has nothing to do with risks inherent. We therefore reject the proposal made in para 9 at all. Associating transactions executed on a trading desk with capital requirements for market risks automatically is neither sound nor justified. The management of transactions on a trading desk may have a variety of reasons, e.g.:

- Any institution has to invest its capital at least to a certain extent into financial instruments. In addition for the purpose of liquidity management money market transactions are performed. Eventually also in the course of the management of FX positions per currency, purchases and sales are to be performed. This is all supposed to be done via a trading desk;
- The execution hedging deals, e.g. interest rate instruments or foreign exchange in order to decrease open positions and reduce risk;
- The LCR regime in the Basel III framework requires institutions to possess a sufficient stock of high liquid assets in order to cover their net outflows over a period of 30 days. Therefore institutions must build up a portfolio with such assets and manage the portfolio thereafter via a trading desk;
- In order to prove the liquidity of high liquid asset required to comply with the LCR regime institutions are forced to “sell” a certain part of their stock of high liquid assets in the market. As institutions are forced to perform best execution these transactions must be performed by a trading desk;
- In order to comply with the recovery and resolution regulation institutions in scope are required to demonstrate the ability to liquidate collaterals;

- In addition in case a real liquidation of collaterals is needed, this needs to be performed by a trading desk as well;<sup>8</sup>
- Performing adequate cash and liquidity management.

From our perspective the intended definition of a trading desk does not fit as it is not specific enough. The enrichment of the “key attributes” to be specific enough would for example include a relationship to (proprietary) trading success (e.g. as one pre-established objective), trading intend or management of open risky positions. As this is already the content of the generic requirements in paragraph 4 and the additional assumptions in paragraph 11 (taking the changes as proposed by us into account), we do not see the necessity to have a trading desk link in the revised market risk framework at all.

On top of the comments raised so far we kindly ask the Committee to clarify the position on securities lending transactions. In general we do not see any market risk resulting from securities lending transactions as borrowed security has to be returned regardless of market price fluctuations in the meantime. The lender in principal is showing the sent security on his balance sheet and is bearing market risk out of this position. However depending on the accounting standard a de-recognition might take place. In such cases the market risk of the underlying security needs to be captured in case the security is part of the trading book.

Moreover securities lending transactions performed in order to increase settlement efficiency should not be part of the trading book at all. Furthermore, any business as an agent to arrange securities lending between two other parties, e.g. in the form a third party agent model should also be allocated to the trading book. This should include models where formally the “agent” acts as principal in a matched principal broking transaction.

However, the Committee should clarify how borrowed securities to cover naked short positions are to be treated respectively how the covered position is seen regarding the “naked” classification of paragraph 11.

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<sup>8</sup> CSDs and CCPs in scope of the Basel framework also might be forced to perform buy-ins in order to fulfil settlement obligations also in principal need to do this via a trading desk.

“Fundamental review of the trading book: A revised market risk framework” – issued for comment by 31 January 2014

In addition to our fundamental concerns on the generic inclusion of certain types of transactions / investments and the overshooting definition of the trading desk as basis for classification as trading book business we also miss an appropriate measure to adequate proportionality.

Despite the indicated room for discretion on page 8 of the consultative document we would welcome a clearly outspoken internationally valid threshold to exclude small trading books from the application of the market risk rules. This exclusion comes of course on top of those positions which are allocated to the banking book. As a second best solution at least a generic rule within the revised framework to allow the exclusion of small trading books subject to national definition from the market risk rules should be included.

As an example the current thresholds as they are already in place in the European Union could be used. The Capital Requirements Regulation (CRR) sets the thresholds for derogation for small trading book business in case following criteria are met:

- a) Trading book business is normally less than 5% of the total assets and 15 million EUR;
- b) Never exceeds 6% of total assets and 20 million EUR.

We strongly encourage the Committee to consider such threshold system in the revised framework as well.

## **D. Conclusion**

The revised trading book definition would lead to increased requirements (capital, organisational efforts, etc.) for entities which are not exposed to any relevant market risk.

The proposed framework is not shifting dedicated business from the banking book into the trading book instead it is carving out the banking book and leads to a situation where only the trading book exists outside traditional client loan business.

Following the proposed framework the bizarre situation will occur that transactions (e.g. hedging deals) which are reducing open positions and therefore market risks lead to additional capital requirements as the transaction is considered on an isolated basis, neither considering the trading intent, nor the effect on exposures at stake, nor the level of potential future market risks.

Our dedicated business model is characterised by an extremely high liquidity and credit quality of our investments. In addition exposures towards clearing members or clients are collateralised to a very high degree. Managing these kinds of transactions with the trading book rulings is not appropriate and therefore shouldn't be required. With the new rulings business models like ours are forced into the trading book although rules do not fit.

In our mind it cannot be the intention of regulators to enlarge regulatory burden on those low risk credit institutions. Of course it must be appropriately covered in case a non trading book credit institution is facing high market risks if they are strongly invested in financial instruments with a medium to high volatility. In this context the factual market risk of an exposure should be the critical parameter instead of the proposed parameters.

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We hope that our comments given are useful in the further process and are taken up going forward. We are happy to discuss any question related to the comments made.

Eschborn, 31 January 2014

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