

**Meeting Between Staff of the Federal Reserve Board and Representatives of the  
International Swaps and Derivatives Association (ISDA) and the Securities Industry  
and Financial Markets Association (SIFMA)**

**March 7, 2024**

**Participants:** Anna Lee Hewko, David Lynch, Brian Chernoff, Aaron Game, Alice Maddrey, Cecily Boggs, Daniel Schwindt, Diana Iercosan, Katherine Arnold, Lesley Chao, Hulusi Inanoglu, Matthew McQueeney, Nadya Zeltser, Robin Oh, Sarah Dunning, Victoria Maizenberg, Vikram Ramnarain, Gillian Burgess, Jonah Kind, and Ryan Rossner (Federal Reserve Board)

Panayiotis Dionysopoulos and Lisa Galletta (ISDA); Carter McDowell (SIFMA); Bengt Redlinger (Bank of America); Manoo Halati (Bank of New York Mellon); Atreya Chatterjee (Citigroup); Alyssa Shcherbakova and Joseph Hwang (Goldman Sachs); Debbie Toennies and Bruce Broder (JP Morgan); Matt Lovett (Morgan Stanley)

**Summary:** Staff of the Federal Reserve Board met with ISDA and SIFMA representatives regarding the agencies' Basel III endgame notice of proposed rulemaking. The ISDA and SIFMA representatives discussed the potential impact of the proposal on their members and reiterated concerns in their comment letter regarding aspects of the market risk and credit valuation adjustment risk requirements in the proposed rule.

Attachment

# U.S. Basel III Endgame NPR Follow up Questions

**March 7<sup>th</sup> 2024**

## Vega Capital – Query 1

### Industry Proposal

***A banking organization should use its front office models in determining vega sensitivities.***

*Under the Proposal, a banking organization would be required to calculate the vega capital requirement for market risk covered positions that are options or positions with embedded optionality, including positions with material prepayment risk.<sup>89</sup> The Proposal appears to provide that a banking organization would use its front office valuation models with respect to generating vega sensitivities and that, accordingly, the fallback treatment would not apply if the banking organization does not generate vega sensitivities with respect to positions for which, although there is some prepayment risk, the banking organization does not generate vega sensitivities. This situation may arise in particular with respect to loans. Similarly, for certain products including corporate bonds and sovereign exposures (such as options on government futures), a banking organization may generate one type of vega sensitivity but not another one. For example, with respect to corporate bonds, a banking organization may generate vega credit risk sensitivities using credit index options but would not generate a vega interest rate risk sensitivity. **In these instances, the fallback mechanism should not apply for interest rate vega given the reflection of vega within the credit risk class, consistent with front office pricing models.***

**Question:** Why is the “fallback mechanism” brought up in the context of vega capital requirement? What does the **highlighted** sentence mean?

### **Response:**

Preamble (Page 64109):

*“The fallback capital requirement would apply in cases where a banking organization is unable to calculate either the sensitivities-based capital requirement, such as **when a sensitivity is not available**, or the standardized default risk capital requirement.”*

### **Industry’s Interpretation of “Fallback Mechanism”:**

- The Industry’s interpretation is that the “fallback mechanism” is applicable only for a position where a bank is unable to capitalize risk generated by the Front Office Pricing Models for that position (e.g., due to an infrastructure issue)
- The “fallback mechanism” is not intended to **capture risks that are not deemed relevant** to front office pricing and risk management. This is why the fallback mechanism was mentioned as not being applicable in the context of vega sensitivities for prepayment risk or credit risk sensitivities for sovereign exposures that are not generated as a result of modelling choices made and validated by banks

## Vega Capital – Query 2

### Industry Proposal

***The scope of the “dimensions” for certain risk factors under FRTB-SA and the assignment for vega in respect of option instruments with undefined maturity needs clarification.***

*The Agencies should clarify several aspects of the proposed dimensions of the risk factors applicable under FRTB-SA for delta, vega and curvature capital given the terminology used in several sections of the preamble and rule text of the Proposal....*

***....Accordingly, references to positions with optionality and undefined maturity as “instruments” in the preamble or as “market risk covered positions” under § .207(c) should be with respect to the benchmark representations of the relevant position subject to capital requirements, not the position itself. Relatedly, references in the risk factor definitions in § .208 to “tenor,” “residual maturity of the underlying instrument,” “remaining maturity of the contract,” “maturity of the option” and “implied volatility” of options should relate to the implied benchmark regulatory positions underlying the risk factor definitions, not to any particular instrument or market risk covered position subject to capital requirements.***

**Question:** Struggling to understand what is being proposed as the solution. It is not clear what the proposal is for dealing with instruments with undefined maturity.

**Response:**

### Industry’s Approach for Capital Computation under FRTB:

- For any instrument (e.g., a 5-year IR swaption or an American equity option), a bank’s front office pricing model would generate sensitivities along the curve (or surface) for various tenor points. These sensitivities are generated by shocking these tenor points on the curve (or surface), which is equivalent to shocking the benchmark instruments that are used to calibrate the curve (or surface)
- The sensitivities thus generated on the Front Office Pricing Model tenors are then re-bucketed to the FRTB SA regulatory prescribed tenors for computation of FRTB capital

## Vega Capital – Query 2 (continued)

However, the following text in the NPR are inconsistent with this approach:

- **Rule text section §\_\_.207, page 64245:** “(3) A [BANKING ORGANIZATION] must assign market risk covered positions that are options or positions with embedded options that do not have a maturity to the longest prescribed maturity tenor.”
- **Preamble page 64117:** “To help ensure appropriately conservative capital requirements, the proposal would require a banking organization to (1) assign instruments with optionality that either do not have a stated maturity (for example, cancellable swaps) or that have an undefined maturity to the longest prescribed maturity tenor for vega, ....”

**Example (taking ‘cancellable swap’ example mentioned in the NPR text):** Vega capitalization of a cancellable swap (with no stated cancellability date) and with a maturity of 5 years.

For this position, the Front Office pricing models will generate vega sensitivities across various benchmark maturity tenors (e.g., 1-month, 3-month, ..., 4-year, 5-year)

- **Method A: Based on literal reading of the NPR rule text:** Vega exposure across all the Front office tenors are aggregated to a single vega exposure that is assigned to the longest FRTB SA prescribed tenor of 5-year. Only the 5-year point is then capitalized
- **Method B: Based on industry’s fundamental understanding of the FRTB rules :** Vega exposures generated by Front office on various tenors are re-bucketed to the FRTB SA prescribed tenors: 0.5-year, 1-year, 3-year and 5-year, that are then capitalized as per the rules

**Conclusion:** The Industry would like to confirm its understanding of the application of FRTB rules, in line with Method B. This approach is the same regardless of whether a position has a fixed maturity, an unstated maturity, or an undefined maturity.

While the industry view is that the rule instructions represent a drafting error, we note for completeness that mapping to the longest prescribed maturity:

- Is generally not conservative (contrary to “to help ensure conservative capital requirements” as mentioned in Preamble page 64117), and
- Diverges from risk management and may result in broken hedges within the capital calculations

## EIIF FRTB-SA – Index Bucketing and Proposed Treatment of MMFs and Government Bond Funds

- The rules should allow banks the option to allocate a fund to an appropriate index bucket without having to decompose it
  - The ability to map to an index bucket should be based on the fund meeting diversification requirements - not on tracking a specific index. For example, banks could use the definition of “well-diversified”<sup>1</sup> for **credit and equity indices** used in the current U.S. NPR<sup>2</sup>
  - The selection of the appropriate index bucket could be based on a fund’s prospectus or mandate
  - Once in the index bucket, the fund’s exposure should be allowed to diversify with other exposures
- In addition to the index buckets for well-diversified credit and equity funds, there should be additional buckets for equity exposures in money market funds, municipal funds, and fixed income funds (i.e., Government Bond Funds, Treasury Funds, and Money Market Funds)
  - The dimensions to allocate to index buckets should be based on asset class, credit quality, and effective duration

**Equity Investment in Funds Buckets**

Well Diversified Equity Fund	75% or more in develop
Well Diversified Equity Fund	
Well Diversified Credit Fund	IG/HY & Eff Duration
Municipal Fund	IG/HY & Eff Duration
Sovereign Fund	IG/HY & Eff Duration
Money Market Fund	
Broad Fixed Income	Eff Duration

- The assigned risk weights to the above buckets should be based on asset class/fund volatilities
  - Based on initial analysis, risk weights should be capped at the equity index risk weights (i.e., 15% - 25%)
  - Money market funds would generate substantially lower risk weights (i.e., 1% - 3%)
- A comparison of 99<sup>th</sup> percentile drawdowns and volatilities (assuming a one month holding period) using the last 4 years of data on S&P 500 and some common fixed income ETFs is show below:

Fund/ETF	99 Percentile Draw Down	Standard Deviation	Duration
S&P 500	-19.64%	5.67%	
LQD	-8.02%	3.29%	8.43
HYG	-12.62%	3.08%	3.55
MUB	-4.90%	1.78%	5.43
AGG	-4.22%	1.73%	6.12
TLT	-7.24%	3.07%	16.63
GOVT	-2.57%	1.11%	5.93

<sup>1</sup> An equity or credit index would be considered well diversified if it contains a large number of individual equity or credit positions, with no single position representing a substantial portion of the index’s total market value.

<sup>2</sup> Note: like indices, banks should be allowed to use the well-diversified definition regardless of whether the index or fund is listed.

## Equity Investments in Funds (EIIIF) (FRTB-SA) – Lookthrough Approach and DRC Challenges

### **Challenges with Lookthrough Approach (LTA):**

- For lookthrough approach (LTA), availability of data is one of the key challenges since Fund Managers do not routinely publish data listing all their underlying holdings (per the NPR, SA calculations will need be performed on a weekly basis)
- LTA also poses considerable infrastructure and computational challenges:
  - A fund may hold other funds, which leads to a complex “nested decomposition” scenario
  - Mutual funds often have many underlying holdings (e.g., > 1000), and generating curvature for each one of them will result in considerable infrastructure cost
  - In some cases, these underlying positions can be options and then vega will need to be generated as well
  - Even an Equity fund may hold small amounts of other types of assets (e.g., non-USD cash, corporate/sovereign bonds), which will necessitate generating a variety of risk factors across multiple asset classes for a single position
- In addition, full decomposition also creates added operational complexities:
  - Since these positions are typically risk-managed at an overall fund level, monitoring, and validation of these granular risk sensitivities at the underlying holding level will require additional processes and resources
  - If a fund has a small exposure to securitized products, then post-decomposition, that component may have to be subjected to governance requirements such as due diligence, which will be very difficult to implement in practice

### **Challenges with DRC:**

- Look through approach has the same data challenge and infrastructure/computational costs associated with computing JtD for each individual underlying holding
- Even when fallback or hypothetical portfolio approach is used for SBM, for DRC a bank will have to review the mandate of each fund to: (a) find the worst risk weight by assuming that the fund invests to the maximum extent in exposures with highest risk weights, and (b) determine whether the risk weight applied to the fund is prudent or if RRAO must apply. This treatment is operationally very cumbersome

## Equity Investments in Funds (EIIIF) (FRTB-SA) – Potential Solutions for DRC

### Risk Weight Calibration

- Any fallback risk weight for the single equity treatment, such as using speculative or sub-speculative risk weights, will be overly conservative for IG or US Treasury funds
- **Proposal:** Allow the fund to be mapped to an appropriate risk weight bucket (e.g., fund with only US Treasuries would have 0% risk weight, IG corporate funds would have 4.1% risk weight)

### LGD Calibration

- Single equity treatment assumes a 0% recovery. This is overly conservative as this does not reflect the inner risk of fixed income funds
- **Proposal:** If a fund's main positions are fixed income instruments, typically senior unsecured instruments, then allow for a 25% recovery rate

### JTD Calculation

- For well-diversified funds, allow the following optional approach whereby banks must apply the approach consistently through time and must use the approach consistently for all market risk covered positions that reference the same fund
- **Proposal:** For well-diversified funds where banks are unable to decompose, calculate the JTD assuming an equally weighted portfolio of  $n$  issuers, each of them defaulting idiosyncratically. For instance, assuming a maximum concentration of 10% (which is in line with UCITS limit) for an equity fund, this would mean shocking the fund's value by -10% and multiplying it  $n = 10$  times



## EIIF FRTB-SA – Hypothetical Portfolio Approach

### Challenges with Hypothetical Portfolio Approach:

#### SBM

- **From the ISDA/SIFMA Comment Letter:** *The proposed hypothetical portfolio approach is too conservative because a banking organization would be required to calculate market risk capital requirements for the decomposed positions in the hypothetical portfolio on a **stand-alone** basis separate from its other market risk covered positions. This approach would not appropriately recognize the risk-mitigating effects of hedging and diversification and would not be sufficiently risk sensitive.*

#### DRC

- As noted on slide 6, the use of the hypothetical portfolio approach for DRC presents similar challenges

### Industry Recommendations:

#### General

- Allow banks to construct hypothetical portfolios based on representative instruments, and not just based on mandate of fund
- Construction / maintenance of portfolios can be governed by banks' internal policies & procedures

#### SBM

- Permit recognition of diversification by allowing funds using the hypothetical portfolio approach to be aggregated alongside other market risk positions but differentiate between issuers where the exposure is held directly vs from a hypothetical portfolio

#### DRC

- **From the ISDA/SIFMA Comment Letter:** *The Associations recommend that a banking organization be permitted to capitalize the fund position as a single name exposure with, for example, the sub-speculative risk weight within the appropriate default risk sector (non-U.S. sovereign positions, PSE and GSE debt position or Corporate positions), and to recognize diversification of the fund's exposure with respect to other default exposures*
- To be consistent with the approach for SBM, we propose to allow DRC to be calculated based on the same hypothetical portfolio used in SBM

## Re-Designations on HQLA

### Issue:

- The asset-liability management (“ALM”) function is responsible for managing interest rate and liquidity risk of a banking organization. ALM activities commonly involve purchases/sales of securities, including through or within affiliated broker-dealers on arm’s length terms for operational and cost efficiencies
- Normal course ALM activities that may result in a designation would, in effect, force ALM functions to transact with external counterparties, which would raise costs, introduce operating inefficiencies and potentially increase interconnectedness

### Industry Recommendations:

- The purchase and sale of securities by a central treasury function for ALM purposes, including through or within affiliated broker-dealers, in arms length transactions should be exempt from the proposed redesignation rules
  - In practice, the central treasury function could be defined with reference to US LCR Rule 22(a)(2) – “the management function in the [BANK] that is charged with managing liquidity risk” – or a similar US regulatory standard that defines the scope of the central treasury function for ALM purposes
- Such securities should be categorized as either trading book or banking book based on their holding by the central treasury function
- At a minimum, similar to the Canadian application of the rule, such purchases and sales of securities that qualify as high quality liquid assets should be exempt from the redesignation requirements

### **Canadian rule**

*“A requirement that re-assignments into or out of the trading book be publicly disclosed at the earliest reporting date.*

*Institutions are permitted to exclude the following from the restrictions on moving instruments between regulatory books noted in paragraphs 71 to 73:*

- *CAD-denominated Level 1 and Level 2A High Quality Liquid Assets (HQLA); and*
- *non-CAD-currency denominated Level 1 and Level 2A HQLA issued by Canadian entities<sup>3</sup>, as defined in Chapter 2 of OSFI’s Liquidity Adequacy Requirements Guideline.”*

<sup>3</sup> Canadian entities include the Government of Canada, the government of a province or territory within Canada, and an agent of any of those governments whose debts are, by virtue of the agent’s governing legislation, guaranteed by the applicable government. Canadian entities also include any body corporate, trust, partnership, fund, and unincorporated association or organization formed under the laws of Canada, including under the laws of a province or territory within Canada.

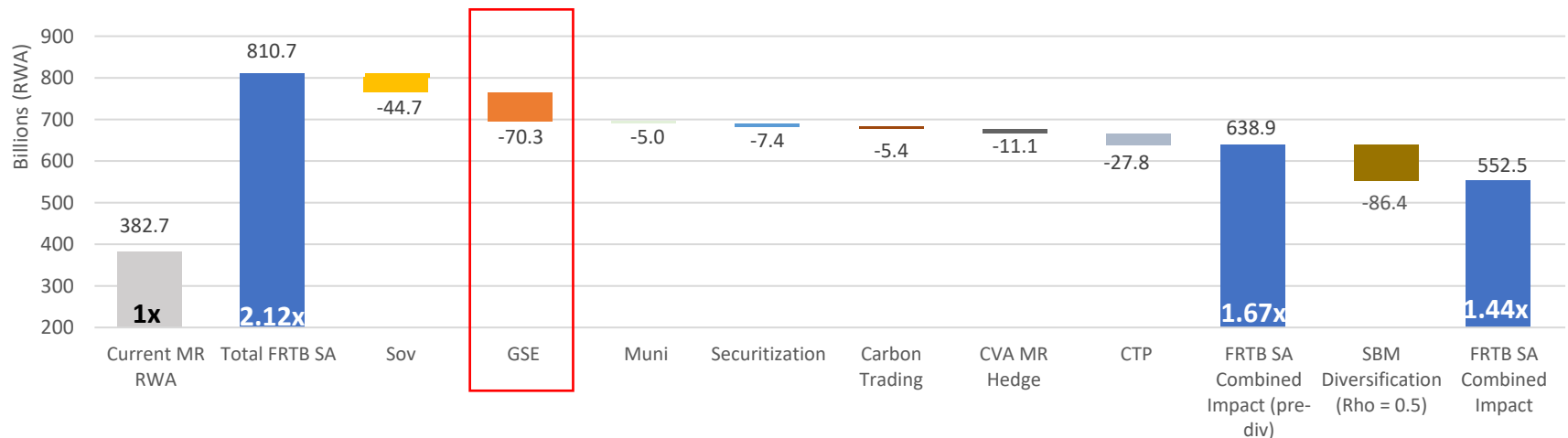
## Treatment of UMBS / TBAs

**Question:** How was the QIS impact for UMBS / TBAs calculated?

**Response:**

- The following table illustrates the treatment for Fannie / Freddie pools and TBAs with and without the industry recommendations:

Exposure type	Without implementation of industry recommendations	With implementation of industry recommendations
Fannie Mae UMBS Eligible Pool	Exposure to Fannie Mae obligor	Exposure to UMBS obligor
Freddie Mac UMBS Eligible Pool	Exposure to Freddie Mac obligor	
UMBS TBA	Exposure to UMBS obligor	
Fannie Mae UMBS In-eligible exposures	Exposure to Fannie Mae obligor	Exposure to Fannie Mae obligor
Freddie Mac UMBS In-eligible exposures	Exposure to Freddie Mac obligor	Exposure to Freddie Mac obligor



- Clarifying treatment of TBAs and UMBS pools:** \$70.3 Bn RWA reduction
- Note that the total FRTB SA RWA figure includes the \$70.3 Bn impact of treating UMBS-eligible pools as exposures to Fannie Mae and Freddie Mac, respectively, and \$11.1 Bn impact of including ineligible CVA hedges. The increase of 112% in market risk RWA under the proposed FRTB SA in comparison to the current capital rules would reduce to 93% excluding the impact of GSE exposures treatment

## Preliminary High Level Comments on the Proposed Regulatory Reporting Requirements

The following list provides examples for categories of industry concerns with the proposed reporting revisions, in particular in relation to timing, confidentiality, cost/benefit consideration and lack of clarity.

### **Timing Issue**

- The FFIEC 102a form (new Supervisory Market Risk Regulatory Report to be submitted by banks subject to IMA) would be required to be filed 20 days after the quarter-end date to review model performance to give supervisors an opportunity to overwrite bank's modelability determination and potentially force a recalculation of risk-weighted assets that would be reflected in the public filings 40 days after quarter end. Given the tight timelines and complexity of reporting requirements across different schedules / reports and senior level sign-offs, any potential required changes would be highly disruptive to established reporting processes and introduce unnecessary operational risks
- **Recommendation:** The Industry recommends to align the filing deadline for the FFIEC 102a report with that of the FFIEC 102 and FR Y-9C. Any adjustments to the modelability determination as reported in the FFIEC 102a report that supervisors deem necessary could be reflected in subsequent reporting cycles as it would generally be the case for issues found in other areas

### **Disclosure of Confidential Information**

- The industry is concerned about the granularity of capital information that is required as part of the FFIEC 102 report. In this context, the Industry proposes to report only an aggregated SBM-based capital amount per asset class instead of providing a breakdown of delta, vega and curvature to reduce the risk of revealing proprietary information to other market participants as these components may be indicative of the positions the bank holds. The granular reporting can be done in the confidential FFIEC 102a report

### **Cost/Benefit consideration**

- The Industry is concerned about the disclosure requirements regarding notional amounts in section 2a-2b (foreign exchange and commodities positions) and 2f (other market risk covered positions). This is due to: a lack of usefulness in assessing a bank's exposure (e.g. foreign exchange exposure may not be based on notional), lack of comparability across banks, and the effort involved in providing this information across all the bank's positions

### **Lack of clarity**

- In relation to derivative and repo-style transaction reporting in schedule RCCR (SLR Table 2), there are instances where current reporting instructions that have been carried over in the new form would benefit from clarifications to ensure that reporting is aligned with the capital rule. In addition, some of the requested granularity in relation to CEU status is not needed for a number of line items
- The Industry notes potential ambiguities with respect to the reporting of repo-style transactions and eligible margin loans in schedule CR1: 1) split of on-balance sheet and off-balance sheet amounts; 2) amounts to be reported for repo-style transactions and eligible margin loans