Industry Comments – Enhancements to Basel II Framework and required revisions to the CBB Rulebook
Rulebook-Volumes 1 & 2 – Conventional/Islamic bank licensees
November 2011

Industry Comments	Ref.	**CBB's response**
General Comments:		
A licensee noted that the bank is ok with the new amendments to the Standardized Approach to Market Risk Capital Charges and Methodology. The bank is not exposed to amended changes pertaining to REPO Style and Securitization deals.		No issues raised. The **licensee** supports the proposal.
A licensee noted that they have reviewed the subject consultation paper and confirm that they do not have any comments concerning the same.		No issues raised. The **licensee** supports the proposal.
A licensee noted that the Bank has no comments in respect to the proposed changes.		No issues raised.
A licensee noted that they have reviewed the revisions to the CBB rulebook – Module CA (Volume 2) which mainly pertains to the methodologies for measurement of Market Risk, specially related to Trading Book and do not have any material comments.		No issues raised. The **licensee** supports the proposal.

Proposed Rule	Comments		CBB's Response
<u>*CA-8.1 Definition of the Trading Book*</u> *CA-8.1.5 Banks must have clearly defined policies and procedures for determining which exposures to include in, and to exclude from, the trading book for purposes of calculating their regulatory capital, to ensure compliance with the criteria for trading book set forth in this section and taking into account the bank's risk management capabilities and practices. Compliance with these policies and procedures must be fully documented and subject to periodic internal audit.*	**A licensee** noted that bank currently does not have a trading book, therefore it urges the CBB to clarify in the proposed amendments if banks do not have a trading book, do they still need to have policies and procedures governing the trading book operations in place?	A	An amendment to this effect can be made. It is not obligatory to have a trading book, but a bank should explain in its high level strategy why and how it does not have a trading book.
<u>*CA-14 Market Risk – Use of internal models*</u> *CA-14.5.1 (i) In addition, a bank must calculate a ‗stressed value-at-risk' measure. This measure is intended to replicate a value-at-risk calculation that would be generated on the bank's current portfolio if the relevant market factors were experiencing a period of stress; and should therefore be based on the 10-day, 99th percentile, one-tailed confidence interval value-at-risk measure of the current portfolio, with model inputs calibrated to historical data from a continuous 12-month period of significant financial stress relevant to the bank's*	**A licensee** proposed using one year historical data starting from 14th October 2007, where this period captures the stressed volatilities that existed during the peak of the 2007/2008 credit crisis. In accordance with CA-14.5, **it** would appreciate the CBB's approval to use the historical data for this period.	B	This is a specific query relative to the concerned bank. The proposal is acceptable.

portfolio. The period used must be approved by the CBB and regularly reviewed. As an example, for many portfolios, a 12-month period relating to significant losses in 2007/2008 would adequately reflect a period of such stress; although other periods relevant to the current portfolio must be considered by the bank.			

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CA-8.2 Prudential Valuation Guidance	**A licensee** noted that a number of clarifications are required in relation to this section. This section titled "Market Risk – Trading Book" is highly confusing as it incorporates valuation guidance for positions in both the trading book and banking book. It also noted that this section requires valuation adjustments be made to Tier 1 capital for the valuation of less liquid positions. And that CBB will need to define the criteria for determining the less liquid positions that require valuation adjustments. It noted that it is not clear whether the valuation adjustments need to be applied to the trading book only or whether these adjustments need to be applied to the banking book as well. It stated that this confusion arises as a result of the earlier reference in this section to the banking book. And that it is strongly recommended to restrict this section to the trading book only consistent with the Basel Committee	C D E	The Bank has a point here. Paragraph 718)c) of the Basel 2 revisions paper states that the scope has been expanded to include all positions that are recorded at fair value and so CA-8.2 should be relocated to a new Chapter CA-16 which would be entitled "Prudent Valuation Guidance". Additional Guidance can be given for less liquid positions to state that generally these would include those holdings of securities and financial instruments which are not loans (or having the characteristics of loan or lease receivables) which do not have market prices or observable inputs to valuation. Given that the Basel text makes it clear (see paragraph 24 of the Basel 2 revisions paper)that this guidance applies to both the trading book and the banking book, section CA-8.2 will be placed as a new chapter and its wording will remain the same, but with extra assistance on what is an illiquid position.

	guidelines. Therefore, the treatment of the valuation adjustments for the banking book should be addressed separately to avoid confusion. **A licensee** also noted that the CBB needs to provide guidance on how the valuation adjustments referred to in CA-8.2.10 to CA-8.2.13 are to be applied. It stated that although CA-8.2.1 lists the factors to be considered in calculating these valuation adjustments, the revised Rulebook should ensure that all banks have a uniform methodology to calculate the valuation adjustments relating to each of the factors.	 F	 These adjustments must be made to Tier one Capital as stated in CA-8.2.13.

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<u>*CA – 6 Credit Risk Securitization Frame work*</u> *CA-6.1.1.A A bank must meet all the requirements listed in the paragraph CA-6.1.1.B below, to use any of the approaches specified in the securitisation framework. If a bank does not perform the level of the due diligence specified, it must deduct the amount of the securitisation (or re-securitisation) exposure from its regulatory capital using the approach outlined in the paragraphs CA-6.4.2 to CA-6.4.4.* *CA-6.1.1.B In order for a bank to use the securitisation framework, a bank must have the information specified below or deduct the exposure from regulatory capital:* *i) A bank must have a comprehensive understanding of the risk characteristics of its individual securitisation exposures, whether on-balance sheet or off-balance sheet, as well as the risk characteristics of the pools underlying its securitisation exposures;* *ii) A bank must be able to access performance information on the underlying pools on an on-going basis in a timely manner. Such information should include:*	**A licensee** noted that: It may be clarified that the requirements prescribed under 6.1.1.A & 6.1.1.B are applicable to new Securitization/ Re-securitization exposures on prospective basis.	G	No comment. These requirements apply to securitization and resecuritisation exposures.

exposure type, percentage of loans more than 30, 60 and 90 days past due, default rates, prepayment rates, loans in foreclosure, property type, occupancy, average credit score or other measures of creditworthiness, average loan-to-value ratio, and industry and geographic diversification. For re-securitisations, a bank must have not only information on the underlying securitisation tranches, such as the issuer name and credit quality, but also the characteristics and performance of the pools underlying the securitisation tranches; *iii) A bank must have a thorough understanding of all structural features of a securitisation transaction that would materially impact the performance of the bank's exposures to the transaction, such as the contractual waterfall and waterfall-related triggers, credit enhancements, liquidity enhancements, market value triggers, and deal-specific definitions of default.*			

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CA – 6 Credit Risk Securitization Frame work	**A licensee** noted that that the risk-weights for Re-securitization under Standardized Approach (SA) is significantly higher than that applicable to Securitization exposures. However, in comparison, the risk-weights for senior positions under IRB (under External Rating Based Approach of IRB) is significantly lower vis-à-vis SA, although the methodology applied in both cases is the same. It may be reviewed whether banks adopting SA are penalized with higher capital requirement for the same risks.	H	The IRB has other costs that the SA does not have and also the IRB may be subject to haircuts. There is an incentive to use the IRB if a bank has significant positions but if not, then the IRB is more costly in other respects.
CA – 6 Credit Risk Securitization Frame work	**A licensee** noted that some countries are yet to adopt the new Securitization/ Re-securitization guidelines for the reason that their banks do not have significant portfolios. It is therefore suggested that exemption from implementation may be sought with respect to these provisions in Bahrain also, or alternatively, exemptions may be provided to banks which do not have	I	Basel 2 does not give exemptions in this respect. If a jurisdiction has chosen to implement Basel 2, then it must implement these revisions. If a jurisdiction has chosen not to implement Basel 2 it does not have to implement these revisions. It should also be noted that some countries had not implemented these guidelines at the time of consultation because they do not have to be implemented until end December 2011 in G20 countries.

	significant portfolio.		
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<u>*CA-14 Market Risk – Use of internal models*</u> *CA-14.5 (j) As no particular model is prescribed under paragraph (f) above, different techniques might need to be used to translate the model used for value-at-risk into one that delivers a stressed value-at-risk. For example, banks should consider applying anti-thetic data, or applying absolute rather than relative volatilities to deliver an appropriate stressed value-at-risk. The stressed value-at-risk should be calculated at least weekly.*	Stress Testing: **A licensee** noted that the consultation paper stipulates a weekly frequency for conducting Stress Tests on the trading portfolio as against the current quarterly requirement. CBB may consider reducing the frequency of stress testing to at least monthly for the banks not having significant trading book / market risk (say the component of market risk in overall risk weighted asset value reckoned for CAR is below 5%), since frequent stress testing will warrant significant investment in systems.	J	This section indicates some of the additional costs associated with the use of models versus the standardised approach. Banks must balance the extra costs associated with models versus the possible benefits they may supply through lower risk charges for lower risk positions and instruments. Basel does not permit selective cherry picking of the cheapest or most beneficial elements of the SA approach and the IRB/internal models approach. Each approach has its costs and its benefits and banks must decide on the approach that is most appropriate in terms of risk management and not look at the approaches purely in terms of cost.

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<u>*CA-14.11 Treatment of specific risk*</u> *CA-14.11.3 Banks which meet the criteria set out above for models but do not have methodologies in place to adequately capture event and default risk will be required to calculate their specific risk capital charge based on the internal model measurements plus an additional prudential surcharge as defined in paragraph CA-14.11.4. The surcharge is designed to treat the modelling of specific risk on the same basis as a general market risk model that has proven deficient during back-testing. That is the equivalent of a scaling factor of four would apply to the estimate of specific risk until such time as a bank can demonstrate that the methodologies it uses adequately capture event and default risk. Once a bank is able to demonstrate this, the minimum multiplication factor of three can be applied. However, a higher multiplication factor of four on the modelling of specific risk would remain possible if future back-testing results were to indicate a serious deficiency in the model.*	Multiplication factors Mc & Ms to be used for calculating capital: **A licensee** noted that the consultation paper stipulates market risk capital requirement as a sum of Normal VaR as well as Stressed VaR as against the current requirement based on only Normal VaR. While for the purpose of current capital calculations, a multiplication factor of 4 for 10 day normal VaR is specified by CBB, the bank presumes that the same multiplication factor would apply for stress VaR also i.e. for both Mc & Ms, which it felt was too stringent. Therefore, the bank requests CBB to consider the factor of 3 both for normal VaR and Stress VaR for select banks whose backtesting results are in compliance with the standard norms (red, green, yellow etc).	K	Again, this section is mandatory for banks using models and reflects the fact that if a bank does not have adequate internal methodologies in place a higher capital charge is required. This is once again a factor to consider in the costs and the benefits of using models or the IRB methodology. The exemption request cannot be considered as this multiplication factor is mandatory.