

## **Standard Chartered Bank (SCB) response to**

**EBA Consultation Paper on**

**Draft Regulatory Technical Standards (RTS):**

**Non-delta risk of options in the standardised market risk approach under articles 318(3), 341(6) and 347 (4) of the draft Capital Requirements Regulation (CRR4)**

### **Summary**

Standard Chartered Bank welcomes the EBA draft RTS proposals, in particular the scenario approach and the delta-plus approach.

### **Responses to specific EBA questions (Q1 – Q8)**

#### ***General provisions***

**EBA RTS CP Q1/p11:** Do you agree with the choice to use the Basel Framework to determine the capital requirements for the non-delta risks of options and warrants? Are there other approaches that can effectively be used for the purpose of these RTS? Which ones? Explain your reasoning.

**SCB response (Q1/p11):** The approaches proposed are adequate given the constraints imposed by the level 1 text in CRR4.

However, SCB notes that:

- CRR4 requires option delta to be calculated for all options under standard rules, both long and short.
- CRR4 requires the local regulator (PRA for SCB Group) to approve sensitivities derived from option pricing models.
- The RTS will be formally adopted in November leaving only limited time to implement new capital calculations before Q1 2014.

SCB will be reviewing with the PRA the minimum standards for options pricing model set out by the PRA Consultation Paper CP5/13 Strengthening capital standards: implementing CRD IV — Appendix 2 Supervisory statements; 5 Market risk ; Section 3 Standardised approach for options.

**EBA RTS CP Q2/p12:** Do you prefer the first option (exclusion of a combination of methods within a single institution) or the second option (exact definition of the scope of the scenario approach)?

Explain your reasoning. If you prefer the second option, what additional conditions and controls should be established?

**SCB response (Q2/p12):** Option 2 is preferred.

Within the organisation, sophistication of trading varies between products and locations, so flexibility is appropriate to cater for the different trading areas. SCB applies internal model for most of its Trading Book options, so standard rules are applied in areas where internal model is being applied for or where this is not cost effective.

To prevent possible cherry-picking we suggest that the RTS makes it a condition that a selected approach is applied consistently in any application (meaning: location, system or product).

### ***Simplified approach***

**EBA RTS CP Q3/p12:** Do you believe that it is useful to implement the simplified approach established in the Basel text?

**SCB response (Q3/p12):** SCB typically holds positions in both long and short options, so the simplified approach is not applicable as it is appropriate for long options only.

### ***Delta-plus method***

**EBA RTS CP Q4/p15:** Do you agree with this prudential treatment, not contemplated in Basel Framework, for non-standard options?

**SCB response (Q4/p15):** Yes, we agree on this treatment for non-continuous options under delta-plus method as it is clear and easy to interpret.

**EBA RTS CP Q5/p15:** Do you agree that the RTS should require that the conditions of Articles 318 (1), 341 (1), 347 (3) of the CRR are met for the calculation of gamma and vega?

**SCB response (Q5/p15):** Yes, we agree that that the conditions being referred to for gamma and vega are the same as for delta: namely that the model is subject to permission by the competent authorities confirming that it appropriately estimates the rate of change of the option's value with respect to small changes in the relevant underlying factor (ie. market price of the underlying for delta; delta for gamma; volatility for vega).

**EBA RTS CP Q6/p16:** Do you think that the unified treatment of interest rate risk is sound? Could there be difficulties in implementing it in practice.

**SCB response (Q6/p16):** The 'unified' approach is appropriate to the products for which SCB expects to apply this approach (interest rate options under standard rules).

However, as noted in the response to question 1, there will be reliance on local regulators to approve option pricing models for interest rate risk. SCB will therefore follow up bilaterally with the PRA.

For interest rate risk sensitivity measurement SCB recommends the use of zero coupon rate yield sensitivities (pv01) rather than yield to maturity (YTM) sensitivity as a better basis for measuring interest rate exposure. Although the results are not usually materially different, pv01 is general industry practice and is routinely applied to portfolios with bond options, IROs and swaptions as well as their underlying instruments.

**EBA RTS CP Q7/p16:** How many hybrid options does your portfolio account for in terms of number of options and notional amounts (i.e. options which can be assigned to more than one underlying type as defined above)? Should the RTS specify the treatment of these hybrid options?

**SCB response (Q7/p16):** Quanto equity options are the only hybrid options that span the underlying asset classes (FX, Commodities, Equities, Interest rates) which SCB holds under standard rules. Quanto equity options are similar to the corresponding equity option except that

the client prefers to receive the pay-off in a different currency from the underlying equity. So it is a hybrid of equity and FX risk. Quanto equity options account for only 5% of SCB equity options (by notional). As of May 31<sup>st</sup> 2013, the gross notional of quanto equity options was US\$840m.

### ***Scenario approach***

**EBA RTS CP Q8/p18:** Scenario approach: allowance for significant option traders

The Basel framework [718(Lxiii)] proposes that Banks that are significant option traders can be allowed to aggregate some time bands in the treatment of interest rate options. The EBA believes it is not clear why institutions that are significant traders (and are therefore rather sophisticated) should be allowed to use a similar approach than other banks. Such a provision is contrary to the proportionality principle (the approach shall be proportionate to the scale and the complexity of the operations of an institution).

Advanced institutions should be expected to use the internal model approach which is more risk sensitive and considers such correlations. The EBA believes that the Basel provision, by reducing own funds requirements for option traders, does not create the right incentives for the use of an internal model. For the exposed reasons EBA proposes not to implement this Basel provision in the RTS.

Do you agree with the rationale behind the exclusion of this provision contemplated in the Basel accord in the RTS? If not, please provide arguments in favor of its implementation.

**SCB response (Q8/p18):** This question relates to scenario approach which SCB does not propose to apply for interest rate options standard rules capital and will therefore not express an opinion.

### **Additional submission regarding Article 7(a)**

SCB raised this same point at the EBA hearing on RTS CP16 on 17 July. The EBA representatives encourage SCB to submit in writing as follows.

Article 7 (a) requires 'Integration of the scenario approach in the institution's risk management process'. This suggests that firms must use exactly the prescribed delta-stripping methodology and price/vol shifts internally. In practice, firms (like SCB) often apply a range of similar, but not identical, scenario approaches for internal risk management purposes.

We would therefore recommend that Article 7 (a) be amended slightly as below, to permit more flexibility in regard to the scenario matrices applied internally, without undermining or contradicting the commitment to the scenario matrices defined for standard rules regulatory capital purposes.

- (a) Integration of a scenario approach in the institution's risk-management process in accordance with Article 368(1)(a) of Regulation (..) No xx/xxxx [CRR];

Note that capital would be calculated exactly as Article 8, so this flexibility is only regarding the internal use of the scenario matrix. This is analogous to CAD2 internal model [ CRR4 Article 368(1)(a)], where firms apply internal model VaR at 95% or 97.5% confidence level and 1-day holding period for internal purposes, consistently with 99%/10-day for regulatory purposes.