Introducing "Basel 4"?… Basel Proposes Changes to Trading Book Market Risk Capital Requirements

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The Basel Committee on Banking Supervisions ("BCBS") have released a consultative paper ("CP"), soliciting comment on the direction being taken by the Committee in regard to changing the methods used to calculate regulatory capital with regards to market risk. The paper's objective is to present a fundamental review, seeking to address the design of the Trading Book regime as well as weaknesses in the measurements of both Standardised and Internal Model approaches.

Background

During the 2008 financial crisis it became evident that many banks had built up materially undercapitalised trading book exposures. The revisions introduced under Basel 2.5 aimed to reduce cyclicality of the market risk framework and to increase the overall levels of market risk capital held by banks, particularly for those areas exposed to credit risk. However regulators are still of the view that the market holds inappropriate levels of capital with regards to the Trading Book. The BCBS proposes further steps to ensure that banks hold sufficient capital to support their trading book post Basel III.

Overview of the Key Changes

The scope of the CP is quite extensive but below is a list of the key changes suggested by the paper.

Definition of the Trading Book

The CP does not consider removing the Trading Book/Banking Book boundary altogether.

The "intent to trade" based boundary between the Trading and Banking Books would be revised however to either:

- a narrower definition of the Trading Book whereby not only intent to trade but also ability to trade and risk-manage the instrument are required or,
- a wider definition which is valuation based, and looks at whether changes in the fair value of an instrument, through earnings or equity, would pose risks to either regulatory or accountancy solvency.

Moving to Expected Shortfall

Value at risk ("VaR") would be replaced by expected shortfall ("ES"), a method of measuring the riskiness of a position by considering both the size and likelihood of losses. ES has advantages over VaR as it captures tail risk. Accordingly Internal Model approaches and the risk weights of Standardised approaches would have to move to an ES basis.

Illiquidity Risk

Basel 2.5 introduced measures through incremental risk charge ("IRC") and comprehensive risk measure ("CRM") to partly address the risks related to illiquid markets. The paper adds three parts to the capital requirements in relation to illiquidity risk:

- Assets would be classified into buckets defined as the time to exit the position in a stressed market environment. There are five proposed bands, from 10 days to 1 year;
- Incorporation of these liquidity horizons in the regulatory market risk metrics; and
- Incorporation of capital add-ons for jumps in liquidity premia, for certain criteria. This seeks to identify instruments where the market risk metrics would not sufficiently capture the risk from large liquidity premia fluctuations, even with the extended liquidity horizons.

The proposal is endeavouring to implement a uniform approach to accounting for endogenous illiquidity risk for banks in the revised models-based and standardised approaches.

Aligning the Internal Model and Standardised Approaches

Potential large differences between Internal Model and Standardised approaches have raised concerns about a level playing field. To address the current framework that has become reflective of private views of risk, it is proposed that there be a closer link between the calibration of the two approaches:

- mandatory calculation under the Standardised approach for all banks;
- introduction of a floor for the Internal Model approach based on the capital charge under the Standardised approach.

Changes to the Internal Models Approach

The perceived weakness in the Internal Model approach would be addressed by:

- strengthening the requirements of portfolios that will be eligible, and
- strengthening the model standards to ensure the output reflects the full extent of the Trading Book risk.

Proposed is to implement Internal Model approaches segmented down to trading desk, so that performance against a model can be accurately measured for each desk. With any desk failing being "switched off" the Internal Model approach. Performance would be measured by how well the models inputs are aligned with what drives the P&L of that desk and by enhanced daily back-testing of the model performance at desk level. The Committee also proposes to introduce a more robust process of assessing whether individual risk factors can be used in each model.

Changes to the Standardised Approach

The Standardised approach, which has the dual function of serving banks which do not require sophisticated models and as a fallback for those banks whose internal models are deemed inadequate, would now also function to harmonise reporting across banks and jurisdictions. The BCBS would require all banks to calculate capital on the Standardised approach so that they have a means of aggregating and comparing on a common basis.

Hedging

The CP also proposes that hedging, which can lead to basis risk, should be capitalised for. The proposal seeks to constrain diversification benefits in the Internal Model approach. Different options for constraining diversification benefits by determining supervisory correlations across broad risk classes are under review.

Stress Scenario based calibration

Finally, the Proposal recognises the practical difficulties in calibration of models to stress periods, even with the new ES measure, and industry feedback is sought on approaches and approximations.

Conclusion

Not all banks have yet fully finalised the implementation of Basel 2.5 nor Basel 3 and CRD 4 and continental divide issues are placing additional strains on change projects. The implications of this proposal would place greater strains on systems and people in the market risk function to provide and review more granular and frequent information. While there is a general consensus that changes are required, we are expecting considerable industry challenge before an implementation date will be set.

We strongly recommend Financial Institutions with Trading Book activities to evaluate the impact of the proposals and respond to the CP.

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