

# Banks still question new trading book rules

Although the Basel Committee has sought to pare back the capital impact of the fundamental review of the trading book, specific asset classes could suffer. *By Philip Alexander*

The largest dealing banks are planning their own impact study on the final fundamental review of the trading book (FRTB) to add detail to the broad analysis published by regulators. The Basel Committee on Banking Supervision (BCBS) published the final rules that will determine market risk-weighted assets in January 2016. The last round of changes mostly involved the calibration rather than the design itself, backed up with the publication of select results from a 2015 quantitative impact study.

“The data provided did not necessarily support granular analysis of the outcomes of the changes to items such as the residual risk add-on or non-modellable risk factors, which had caused concern in earlier drafts. We believe that the BCBS will be using a later review with mid-2016 numbers to calibrate standardised floors for the internal model approach, and banks want to assess the data themselves to be able to feed back into that process,” says Jouni Aaltonen, a director in the prudential regulation division of the Association for Financial Markets in Europe (AFME).

Earlier studies by the industry suggested that add-ons for residual risk in the standardised sensitivities-based approach (SBA) and for non-modellable risk in the advanced internal modelled approach (IMA) could both have punitive effects on the overall capital requirement for market risk. Moreover, by definition these add-ons are not risk-sensitive. Aligning capital more closely to risk was a stated objective of the FRTB.

On both issues, the BCBS appeared to soften its stance in the final draft. The residual risk add-on, previously set at 1% of gross notional amounts, has been cut to 0.1% for those instruments bearing residual risk that are deemed not to be exotic. It will remain at 1% for exotic positions.

“The final text does not say definitively what constitutes an exotic derivative, so there is some confusion, and there will need to be some clarification, perhaps

from each local regulator, over the coming months,” says Ram Ananth, head of the quantitative practice at financial risk management consultancy Avantage Reply in London.

For non-modellable risks, Mr Aaltonen says the BCBS decision in the final draft that banks can assume zero correlation between credit spread risks is an improvement and is in line with industry practices.

## Work in progress

The revised market risk framework will enter force at the start of 2019. Even with the latest publication, however, the FRTB is not complete. The January 2016 paper has left room for a number of further elements to be fitted into the market risk framework. First, the BCBS is reviewing possible exemptions for market-makers from capital deductions for holding other banks’ capital securities. In particular, an initial BCBS paper on total loss absorbing capacity (TLAC) in November 2015 proposed that any holdings of another bank’s TLAC equivalent to more than 10% of a



**Jouni Aaltonen**

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bank’s equity should be deducted from its own capital ratio.

Other elements under review include a preferential market risk treatment of securitisations classified as simple, transparent and comparable (STC), the treatment of sovereign risk, and the linkage between the FRTB and credit valuation adjustments (CVA) for counterparty risk on derivative positions. The STC initiative will complement moves already under way to reduce risk weights on qualifying securitisation

tranches held on the banking book (see pp. 14-15).

“Although they have been reduced in the final version, the market risk capital charges for some securitisations are still punitive and the impact on dealer banks active in this market is likely to be higher than the mean capital increase of 22% indicates. The STC proposal will help, but there are pockets of important securitisation activity that may not qualify for one reason or another, and market-making in those transactions will be heavily penalised,” says Mr Aaltonen.

Mr Ananth says a new CVA framework on which the BCBS consulted last July could interact specifically with the non-modellable risk factors in the FRTB.

“That could be important, especially for the treatment of proxy credit spreads in the CVA capital calculation for counterparties that do not have available market-derived credit spreads. Banks will need more work to determine how the final rules impact overall capital requirements,” says Mr Ananth, a former market and CVA risk business analyst at Nomura.

The latest FRTB also excluded the important question of how the revised market risk rules will be fitted into Pillar 3 public financial reporting requirements for banks. The BCBS plans to begin consulting on this topic later in 2016.

“The new framework focuses on tail risk and extreme events, for instance the replacement of value-at-risk with expected shortfall models. There will need to be some careful thought on the granularity of financial reporting to the investor community on those aspects,” says Mr Ananth.

The industry has broadly welcomed the gradual and responsive approach taken by the BCBS. AFME and two other industry associations published a short general response that commended the “commitment to review the rules over time, incorporating outputs from other important regulatory initiatives, such

as treatment of sovereigns and [STC] securitisations”.

## Sting in the tail

Some developments in the final draft of FRTB were much less welcome, however. Top of that list was a minimum 1.5 times multiplier to turn the risk-weighted asset (RWA) calculations into capital requirements. Local regulators can choose a higher multiplier if they consider it appropriate.

Market participants believe this multiplier was not added by the BCBS itself, but by its oversight body, the group of central bank governors and heads of supervision. Hence it arguably has no quantitative basis, but is instead a large extra safety margin thrown in at the very last stage.

Overall, the BCBS impact study suggested a weighted average 40% rise in the capital requirements for market risk using internal models. Based on the mean, the SBA would produce capital requirements around 1.4 times higher than the IMA, but the numbers vary significantly across risk classes. Market RWAs would rise to 10% of total RWAs, from 6% at present.

“If you look into the details of the impact study, the capital requirement from the SBA is three times higher than the IMA at the 75th percentile. Our own work on the numbers earlier in the process suggested that the aggregate impact is closer to the 75th percentile than to the mean, because the larger capital markets institutions will see more significant increases in capital requirements depending on the asset classes in which they are active,” says Mr Aaltonen.

This will have knock-on implications for the BCBS plan to use standardised approaches as a floor for internal models. And the rise in total RWAs will also feed through into the TLAC requirement, which is calculated as a proportion of RWAs.

“Market RWAs may remain a relatively small part of those banks’ total balance sheets, but the implications for activity in the capital markets themselves are more significant,” adds Mr Aaltonen.

Those implications will be uneven, due to some other late changes to the calibrations. One crucial area of concern with earlier drafts was the use of liquidity horizons for internal models – differing lengths of time that banks must assume

would be required to sell down each asset class. Longer liquidity horizons lead to heavier capital requirements. Market participants were concerned about procyclical cliff effects because the liquidity horizon jumped from 20 days to 60 days if a sovereign bond were downgraded below investment grade. The high yield sovereign liquidity horizon has now been cut to 40 days, and horizons have also been eased for a number of other exposures including high yield corporate bonds and small cap equities.



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“These are all positive measures for trading in emerging market assets, and should also be important for the European capital markets union project that is intended to treat small caps more favourably,” says Mr Aaltonen.

By contrast, in the SBA, the BCBS substantially scaled up the shock assumptions that must be applied to foreign exchange (FX) and interest rate risks. Market participants understand that the change to FX methodology was designed to incorporate the risk of a previously pegged currency being floated. A number of major FX dealers suffered significant losses when Switzerland allowed the Swiss franc to float in January 2015, leading to a 15% appreciation in just one day. However, the larger shock to interest rate assumptions has not been explained, and came as a major negative surprise.

Other hard-hit asset classes are less controversial. In particular, correlation trading instruments such as exotic collateralised debt obligations face liquidity horizons of 60 to 120 days. Such instruments were particularly hard hit during the financial crisis, and their use by investment banks has declined significantly.

## Drawing boundaries

As FRTB moves to the implementation phase over the next three years, the quantitative impact studies mean most large dealing banks have already prepared

for the major changes in model methodology, such as the adoption of expected shortfall. The more challenging aspects will relate to supervisory sign-off on decisions taken by the bank.

One of those will be the boundary between banking and trading book assets. The BCBS has sought to eliminate opportunities for capital arbitrage by moving assets between the two books, but the allocation of positions is not always straightforward.

“Banks often sell mortgage products with interest rate or other derivatives embedded, for instance to manage and hedge out prepayment risk. The embedded derivatives could go on either side of the boundary, so banks will need local regulatory guidance to choose which path to follow,” says Mr Ananth.

Another crucial innovation is the identification of separate trading desks, each of which must seek approval to use the IMA individually. Previously, IMA approval occurred at the level of the bank’s legal entity running the trading activities.

This desk-level approval provides the option for regulators to reject one desk’s internal models and return it to the SBA. The BCBS plans to conduct a further quantitative assessment of IMA profit and loss (P&L) attribution later in 2016, which will intensify the scrutiny of whether banks are capturing all risk factors sufficiently in their internal models for each desk.

“This will calibrate the P&L attribution test to a meaningful level. Appropriate calibration is important for this supervisory tool to ensure the robustness of banks’ internal models at the trading desk level,” the BCBS noted.

Mr Ananth says the division of market risk into separate trading desks could be a “massive challenge” for many banks. “The banks will need to go through internal processes, and cross-border investment banks will need to get each desk approved globally,” he says.

However, for those banks subject to the US Volcker Rule that prohibits proprietary trading by institutions benefitting from federal deposit insurance, their US operations will already have defined individual trading desks in order to prove each desk does not engage in proprietary trading. The banks should be able to apply those processes to help comply with FRTB desk-level approvals. **GRR**