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Fundamental Review of the Trading Book

Trading in the Future

The Fundamental Review of the Trading Book is a major challenge for the banking sector since it requires firms to rethink the processes and methods for measuring and calculating risk, to revisit their business strategy and to adapt their organizational structure.

As a global professional services company, we offer financial services clients a comprehensive and holistic approach to managing regulatory requirements supported by a global network of skilled and knowledgeable professionals.

Time is ticking... be prepared!

In January 2016, the Basel Committee on Banking Supervision (BCBS) published its last update on the revised minimum capital requirements for market risk, which represents a key outstanding element of the post-crisis reforms. All banks are required to finalize the implementation of the revised market risk standards by January 2019 and to start reporting under the new standards by the end of 2019.[1]

Key features

Among the key features of the revised framework we find:

- A revised boundary between the trading book and banking book
- A revised and standardized approach for market risk
- A revised internal models approach for market risk

These are expected to have a significant impact on banks.

Revised boundary[2]

As per the BCBS rules, the revised boundary has been strengthened to discourage regulatory arbitrage. The change strongly restricts the current discretionary approach in the assignment and future reallocation of an instrument between the banking book and the trading book. Any deviation will be subject to Supervisor approval and will not result in a positive advantage in terms of the firm's capital requirements.

Revised and standardized approach[3]

The standardized approach has been revised to create a more risk-sensitive framework to address the shortcomings of the current standard approach that revealed to be inappropriate in guaranteeing sufficient amount of regulatory capital during the latest financial crisis.

Moreover, the standardized approach is expected to become more relevant to banks as it serves as a fallback and a floor to the internal model approach (IMA).

What's new?

In the final version of the regulation, most of the risk factors pertaining to the sensitivity-based method have been amended.[4]

The most notable change refers to the treatment of Credit Spread Risk (CSR) that has been softened by reducing the risk weights and making securitizations less capital-consuming.

According to the BCBS, banks would have to increase their capital for trading books by about 40%, while in a previous draft of the rules the rate was 74%.[5]

Nevertheless the securitizations are still subject to the Standardized Approach (SA), making their capital requirements severely expensive.

And as Residual Risk Add-On (RRAO) impacts heavily on the overall capital charge, the regulator has reduced the weights in the calculation formula (1% weight for exotic instruments and 0.1% for "others") to soften the RRAO's impact on capital.[6]

The BCBS has also brought clarity to areas such as cross currency basis risk by establishing a single cross currency basis (over USD or over EUR).[7]

Unfortunately, the new release of the regulation doesn't address some principal concerns like asymmetric correlations which may lead to unrealistic charges or credit risk double counting.

Revised internal models approach

The enhancements made to the current internal model framework, appear to be driven by a need to make the framework more robust. Hence, the BCBS has concentrated on the following related tasks: a) prudently capture tail risk (Expected Shortfall - ES) and market illiquidity risk (Liquidity Horizon - LH); b) create a more granular standard for the approval process and model validation at the trading desk level; c) attenuate the capital-reducing effects of hedging and portfolio diversification.[8]

What's new?

The BCBS has reassessed certain elements of the internal model framework, such as capitalization of risk factors, backtesting, liquidity horizons, data quality and default risk formulas.[9] The most notable change refers to the increase of the ES multiplier from 1 to 1.5, which should lead to higher capital absorption.

As for non-modelable risk factors which provoked much discussion within the industry, the new BCBS regulation introduces the concept of idiosyncratic credit spread risk, for which a separate treatment is provided to calculate the capital charge. Yet, the treatment of many risk factors as non-modelable, due to strict definition, should lead to higher charges.

Among the positive impacts of the new regulation, is the ability to continue to use the IMA approach in some exceptional cases, like during periods of market stress. This despite the fact backtesting and P&L attribution could provide negative outcomes.

The introduction of diversified liquidity horizons was a major concern to the industry. The "softening" of the liquidity horizon rules in the latest regulation should be well received by the industry and seen as a positive outcome of its collaboration with the BCBS.

The impacts and challenges

The Fundamental Review of the Trading Book will impact banks and financial institutions across all their functions. In order to effectively cope with these impacts, firms should distinguish between:

Business model strategies

Banks should actively manage the upcoming changes to strike the right balance between profitability and capital absorption, through a restructuring of their business model.

Methodologies and processes

Banks should expect to face important challenges in implementing their capital charge calculations within SA and IMA. In the case of the latter, a key issue will be switching from value-at-risk (VaR) to ES. Moreover, the new desk level approach for reporting and validation imposes changes to all the related processes and procedures.

Systems and infrastructures

Banks should focus and commit to updating and integrating their systems and infrastructure to support the computational and operational tasks (e.g. availability of sensitivities, market data, implementation of most sophisticated simulation among others).

Industry reaction

A number of crucial issues are forcing banks to re-evaluate their investment model to stay competitive and relevant in the market.

Business model strategy

A number of Tier 1 banks have already outlined plans to reduce their investment business, partly because of the higher capital demand reshaping their overall investment strategy.

Methodology and processes

Thanks to Quantitative Impact Study (QIS) results, we have observed that several banks have already started working on these new methodology implementation and process reviews, as well as "what if" analysis about what direction to take: Sensitivity-Based Approach or Internal Model Approach?

Systems and infrastructures

Integration within the front office, pre-trade risk, and capital and cost transparency is in our view crucial to maintaining competitiveness.

Where are you on this journey?

Considering the impacts and challenges, banks should consider restructuring their operational models.

We suggest they conduct a quick assessment to understand their positioning in order to take proper and timely actions.

There are some essential questions that should be addressed as part of the initial diagnostic framework and that can help banks to identify key tasks, milestones and timing.

Quick assessment questions

Have you quantified the trading book management controls?
- More active management of trading book positions
- Increased requirements on organization, infrastructure and risk management
- Additional documentation and control effort
- Can you align them to the Volcker Rule Controls?

Fundamental question: Which business is run through the internal models?
- Complete rework of standard and internal market risk models
- Increased requirements on data quality
- Additional organizational and operational requirements
- Infrastructure for calculating/comparing standard approach and internal model results

How do I avoid capital traps through effective liquidity management?
- Higher capital requirements through liquidity premiums
- Increased modeling effort
- Increased requirements on data quality

How do I improve my hedging and diversification under the new rules?
- Increased costs for hedging strategies and higher requirements for market risk management
- Required adjustment to the internal market risk model
- Higher capital requirements

Have you considered revisions to the market risk capital framework?
- Consistent implementation across different jurisdictions
- Planned step-by-step transition to the new market risk framework
- How much to spend on the implementation? Is it too much to handle?

Source: Accenture, February 2016

How Accenture can help

Accenture support can be tailored depending on each bank's particular situation, their business needs and how it will be impacted by these new requirements, including in areas such as trading activities, the use of internal models and their risk management framework. Accenture's team of global professionals have deep experience in managing regulatory assignments across regions. They bring a high level of skill, knowledge, insight and capabilities, and can support banks and financial institutions in the following areas:

Strategic and operational advisory

- Governance model and internal policies review, with a focus on redefining the trading book boundary
- Support in qualifying the accuracy of the bank's internal risk model, focusing on: P&L attribution and backtesting activities
- Data quality improvement for risk data aggregation implementation (revised standard approach), increasing datasets for each type of risk

Tools and key accelerators

- Standard method tool to perform a capital absorption analysis
- Structured process to calculate the Expected Shortfall
- Independent model risk assessment tool to help create an appropriate level of control of market and credit risk
- P&L attribution to ascertain the accuracy of the valuation models (comparison of actual and theoretical P&L plus a test on the capturing capacity of risk factors)
- Data management system and process methodology enhancement

People, partnerships and global experience

- Team of professionals with specific skills and competencies (from compliance to operational) operating in key roles
- Access to global experience, resources and cross-region benchmarking information, insight and knowledge
- Accenture's global network capabilities and local knowledge of regulatory requirements

For more information, please contact:

Italy, Central Europe and Greece

Paolo Brognara (Managing Director)
Email: paolo.brognara@accenture.com
Tel: +39 335 873 5387

Abulenta Librazhdi (Manager)
Email: abulenta.librazhdi@accenture.com
Tel: +39 327 579 0806

Spain, Portugal, Africa and Israel

Gimenez Martinez (Senior Manager)
Email: j.gimenez.martinez@accenture.com
Tel: +34 608 033 438

United Kingdom and Ireland

Peter Beardshaw (Managing Director)
Email: peter.beardshaw@accenture.com
Tel: +44 20 7844 7550

Takis Sironis (Senior Manager)
Email: takis.sironis@accenture.com
Tel: +44 20 3335 0457

France, Netherlands, Belgium and Luxembourg

Kim Tran (Senior Manager)
Email: kim.tran@accenture.com
Tel: +33 1 5652 6833

Norway, Sweden, Denmark, Finland and Latvia

Tales Lopes (Managing Director)
Email: tales.s.lopes@accenture.com
Tel: +55 11 5188 1883

Austria, Germany and Switzerland

Markus Tentler (Senior Manager)
Email: markus.tentler@accenture.com
Tel: +49 6173 94 67391

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