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Expert Analysis

Basel Committee Turns Attention to Market Risk (Again)

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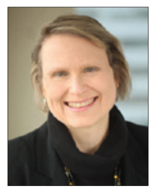

The Basel Committee on Banking Supervision of the Bank for International Settlements in Basel, Switzerland, is a group of international banking regulators that, among other responsibilities, proposes international capital standards. After the financial crisis beginning in 2008 demonstrated that the previously adopted market risk standards did not provide for sufficient capital to absorb the large trading losses that had occurred, the committee adopted partial revisions in 2009 and declared that it would undertake a thorough review of the standards.

In May 2012, the committee issued its first consultative document on this issue and based on comments it received, on Oct. 31, 2013, issued a second consultative document (Consultative Document), this time with specific proposed revisions to the Basel Capital Accord's market risk provisions.[1] The deadline for comments is Jan. 31, 2014, and international banks may want to review the proposals closely to determine what effect they would have on their trading operations. The committee plans to carry out a Quantitative Impact Study (QIS) in order to test these proposals on real bank trading portfolios. This month's column will provide a general overview of the issues discussed in the Consultative Document.

Overview and Focus

Market risk has been defined as the risk of losses arising from movements in market prices. The specific risks included within the market risk calculation for financial instruments on the trading book are interest rate risk, credit spread and default risk; equity risk, foreign exchange risk, and commodities risk.

The committee believed that one of the weaknesses of the current market risk standard is the method by which instruments are assigned to a bank's trading book or its banking book: The banks themselves assign instruments to a particular book. In an attempt to simplify the requirements, provide for more comparability and reduce the temptation for regulatory arbitrage, the committee has proposed building more objective criteria into the distinctions between the trading book and the banking book, and making it difficult to switch instruments between the two books.

Under Basel III, banks have the option of using a standardized approach to calculating risk-based capital, which is similar to what was contained in the first Basel Capital Accord but updated to more closely address the key elements of banking risk, or using their internal models with the approval of the home country regulator.

The Consultative Document proposes to tie the two approaches more closely together by requiring all banks to calculate market risk using the standardized approach, regardless of whether they also use the internal models approach.

In proposing changes to the internal models approach, the committee is proposing to strengthen both the requirements and criteria for the internal models so that they more closely reflect relevant trading book risks. In proposing changes to the standardized approach, the committee is seeking to provide a method for capital calculation of the trading book that does not require a sophisticated measurement of market risk, that will be a workable alternative should regulators reject a bank's use of its internal models and that facilitates transparent, consistent and comparable reporting of market risk across banks and jurisdictions.

What Is a Trading Book?

The committee notes in the Consultative Document that it believes that the current method for designating instruments for the trading and banking books has been a source of weakness under the current market risk standards. Banks have been left to self-regulate, leading in some cases to suspected regulatory arbitrage because of the differences in capital treatment for the same instrument depending on the book in which the instrument appears. To address those concerns, the committee has proposed several changes.

Currently, there is no formal definition of a trading book—the assignment of an instrument depends merely on the bank's self-declared intent that it should be assigned to the trading book. The committee proposes to define the

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trading book as all financial instruments and commodities held with (i) the intent of a short-term sale, (ii) an expectation of profiting from short-term price movements or locking in arbitrage profits or (iii) the desire to hold the instrument as a hedge against risks resulting from the other instruments on the trading book. In addition, there must be no legal impediment against selling or fully hedging the particular instrument.

The committee is proposing that there be a general presumption that certain instruments are to be assigned to the trading book:

- Instruments held as an accounting trading asset or liability
- Instruments resulting from market-making or underwriting activities
- Equity investment in a fund (where a daily price may be determined)
- Listed equities
- Naked short positions, including any short position in cash instruments
- Options

The committee also is proposing general presumptions regarding instruments to be assigned to the banking book:

- Unlisted equities
- Instruments designated for securitization warehousing
- Real estate holdings
- Equity investments in funds (including a hedge fund) where the bank cannot look through the fund daily or where the bank cannot obtain daily real prices for its equity investment in the fund
- Derivative instruments where the underlying assets are other instruments meeting the banking book general presumptions

Banks will be expected to have detailed policies and procedures on the assignment of instruments to its trading and banking books and to conduct an ongoing evaluation of the instruments held on both books.

Risk Management

Banks will be expected to have clearly defined policies and practices that will ensure active risk management of the instruments in the trading book, whether marked-to-market or marked-to-model. Banks are expected to manage the market risk in the trading book so that they are always in compliance with the capital requirements, including at the end of each business day, and to avoid excessive intraday exposures. The current requirement is to have daily valuation at readily available closed-out prices; the proposed revision is to require all instruments in the trading book to be fair-valued daily through the bank's profit and loss statement. Another new requirement would be the maintenance of extensive information on the operations of the trading book to be provided for review by regulators.

The market risk requirements are applicable on a worldwide consolidated basis. The committee is not providing any de minimis exceptions to the market risk capital requirements, except for certain foreign exchange risks.

What Is a Trading Desk?

In the Consultative Document, the committee for the first time proposes a definition of a trading desk as "a group of traders or trading accounts that implements a well defined business strategy operating within a clear risk management structure."[2]

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A bank is permitted to identify its trading desks but supervisors must approve the designations for purposes of calculating capital. The committee sees the key attributes of trading desks as including (i) a clearly specified group of traders or trading accounts with a designated head trader; (ii) clear reporting lines to senior management and a formal compensation policy linked to its pre-established objectives; (iii) a well-defined and documented business strategy; (iv) a clear risk management structure; and (v) application of the market risk capital rules in the same manner to both internal hedges between trading desks and to external hedges.

Strict Limits on Transfer

Currently, switching instruments between the trading and banking books is allowed because it is the bank that determines whether there has been a change in its intent to hold an instrument on one book rather than another. The committee is proposing the imposition of strict limits on being able to move an instrument between the banking book and the trading book once initially designated by the bank.

It is anticipated that such transfer will only be permitted under extraordinary circumstances, such as a bank closing its trading desks. Market events, changes in liquidity of an instrument or change of trading intent alone will not be seen as extraordinary circumstances justifying a transfer of an instrument from the trading to the banking book. Any change must be thoroughly documented, in accordance with the bank's internal policies and procedures, and approved by senior management and the relevant regulator. Once changed, the transfer cannot be reversed.

Regulators also would have the ability to require banks to move a particular instrument from one book to the other if it deems the instrument to have been improperly designated; this is a new requirement.

Moreover, in order to avoid regulatory arbitrage, should an approved transfer between books result in a reduction in capital held against that instrument, the bank would be required to add the difference between those two figures back into the capital calculation so the bank cannot take advantage of the lower capital treatment. Currently, there is no capital arbitrage mitigation measure such as the one being proposed in the Consultative Document.

Revised Approach

The Consultative Document proposes that the standardized approach be calculated by all banks and reported monthly (and on demand) to regulators and disclosed in their public reports. The committee believes that setting such market risk capital calculations as a floor could foster a level playing field by creating a common application of the new trading book regime across banks and jurisdictions, but it has not yet made a final decision, preferring to assess the results of the upcoming QIS.

Before beginning its capital calculation under the revised standardized approach, a bank will need to "decompose" each instrument in the trading book into a "notional position," which in most cases will be the market value, the notional value or the discounted cash flows of the instrument.

The Consultative Document first sets out general principles for decomposing 22 instruments by type (e.g., bonds and convertible bonds, equities, commodities and securitizations). After setting out the general principles for instruments by type, the proposed revised standard then drills down in more detail on the 17 instruments the committee considers to be the most commonly traded by banks. Finally, detailed formulas are proposed for determining the capital charges, per asset class, for general interest rate risk, credit spread risk, equity risk, commodity risk, foreign exchange risk and default risk.

If there is not a specific approach listed for a particular instrument, a bank should apply the revised standard's general principles and consult with its regulator, which will provide the appropriate percentage of the notional or market value of the particular uncategorized financial instrument for the bank to use in its capital calculation.

Internal Models Approach

There is no change in the current requirement that any bank wishing to use the internal models approach must receive the specific approval of the regulator. In determining whether to approve a bank's use of its internal models, the regulator, at a minimum, must be satisfied that the bank has (i) a sound risk management system with qualified staff, (ii) internal models with a proven track record of reasonable accuracy in measuring risk, (iii) regular stress testing, and (iv) positions in the internal model for regulatory capital requirements that meet specified model validation standards.

Banks using the internal models approach will be expected to have strong risk management. Any significant changes to an approved model would of course have to be approved by the supervisor prior to being implemented. In addition, the bank would be expected to have at least annually an independent review of its risk measurement system by internal or external auditors.

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Even if approved to use its internal models for some or all of its trading activities, a bank still will have to calculate at least monthly the standardized capital charge for each trading desk. In addition, regardless of the robustness of a bank's internal models, all securitized products are ineligible for the internal models approach because the committee believes that there are significant risks in securitization positions that are difficult to appropriately measure using an internal models approach without creating unacceptable levels of variation in capital across firms.

The Consultative Document calls for regular reports to be made to the regulators on the operation of the internal models, including the results of stress tests of their portfolios. Stress-testing results also should be reviewed regularly by senior management.

Finally, in addition to any internal testing done by a bank, any review by external auditors and/or regulators of a bank's internal models should include consideration of the following:

(a) Are the formulas used in the calculation process validated by a qualified unit independent from the trading area?

(b) Is the structure of the bank's internal models adequate for the bank's activities?

(c) Does the bank ensure that the internal models provide a reliable measure of potential losses over time?

(d) Are the data flows and processes associated with the risk measurement system transparent and accessible?

Disclosure Requirements

Finally, trading book disclosures have not been as extensive as those for the banking book. The committee determined that improvements in these disclosures were needed and is proposing that all banks disclose certain standardized information regarding their trading operations, with banks using the internal models approach to provide additional information on the characteristics of the internal models used.

Conclusion

This Consultative Document sets out an ambitious agenda in its proposed revisions for calculating market risk and handling of the trading book. While the committee will carry out its own Qualitative Impact Study, internationally active banks with substantial trading activities may not want to wait for the committee's study and instead conduct its own internal testing to determine the results of an application of the new standards. Being able to use those results to demonstrate which proposed revisions are workable and which are not may be the best way to assist the Basel Committee in its finalization of the proposed revised standards.

1. "Consultative Document: Fundamental Review of the Trading Book: A revised market risk framework," The Basel Committee on Banking Supervision, available at www.bis.org.

2. Consultative Document, page 51.