March 29, 2018

Bank Capital Requirements

Basel Committee Proposes Revisions to Market Risk Capital Requirements

SUMMARY

On March 22, 2018, the Basel Committee on Banking Supervision (the "*Basel Committee*") proposed revisions to its minimum capital requirements for market risk (the "*Consultation*"),[1] which would amend the final market risk framework published in January 2016 (commonly referred to as the fundamental review of the trading book or "*FRTB*").[2]

The Consultation proposes revisions to both the standardized approach and internal models approach adopted under the FRTB as well as the scope of positions subject to the FRTB. In addition, the Consultation proposes to implement a revised "simplified alternative" to the standardized approach based on the Basel II standardized approach, in contrast to a simplified version of the FRTB's standardized approach proposed in June 2017.[3]

The Consultation also amends the implementation date for Pillar 3 market risk disclosure requirements to January 1, 2022, which aligns with the revised implementation date for the FRTB as announced in connection with the December 2017 finalization of the Basel III capital framework (commonly referred to as "*Basel IV*").[4]

Comments on the Consultation are due by June 20, 2018.

BACKGROUND

The FRTB was intended to address the perceived shortcomings of the Basel II market risk capital framework, in particular the Basel Committee's view that the Basel II framework did not sufficiently capture "tail risk" or the risk of market illiquidity.[5] After publishing three sets of consultative documents, the Basel Committee finalized the FRTB in January 2016.[6]

The principal changes to the market risk framework implemented in the FRTB are as follows:

- ***Standardized Approach***. The FRTB substantially amended the Basel II standardized approach for market risk (the "*Standardized Approach*") so that it could serve as a credible fallback for, and floor to, the internal models approach for market risk (the "*Internal Models Approach*"). Under the FRTB, the Standardized Approach generally calculates market risk capital requirements based on three components:
  - a sensitivities-based method that calculates capital requirements based on delta, vega and curvature risk factor sensitivities with respect to a prescribed set of risk classes;[7]
  - a default risk charge for prescribed risk classes with limited hedging recognition;[8] and
  - a residual risk add-on intended to capture risks beyond those captured in the sensitivities-based method and default risk charge.
- ***Internal Models Approach***. The FRTB introduced enhanced conditions for approval to use the Internal Models Approach with respect to individual trading desks and provides a comprehensive approach for measuring risk and calculating related capital requirements, including with respect to non-modellable risk factors ("*NMRFs*"). The FRTB also transitions from a Value-at-Risk ("*VaR*") measure of risk to an expected shortfall measure, which the Basel Committee indicated would be more effective at capturing "tail risks" in periods of significant market stress.
- ***Incorporation of Liquidity Horizons***. The FRTB introduced varying liquidity horizons into the Standardized Approach and Internal Models Approach that address the risk of severe market illiquidity, replacing a static 10-day liquidity horizon.
- ***Boundary between Banking Book and Trading Book***. The FRTB revised the boundary between the banking book and trading book to provide more objective and detailed criteria that would reduce opportunities for "arbitrage" in calculating capital requirements.

The U.S. banking agencies did not publish a notice of proposed rulemaking addressing implementation of the FRTB for U.S. banking organizations.

DISCUSSION

We have outlined below the key proposals and items for further comment and evaluation described in the Consultation.

- ***Standardized Approach***. The Consultation notes that the Basel Committee has been monitoring the impact of the Standardized Approach and that, in some areas, there are disparities between the level of capital requirements under the FRTB and the actual risk faced by a banking organization. The Consultation proposes to revise certain elements in order to align the overall level of FRTB capital requirements with the initial expectations of the Basel Committee.
  - The Consultation would reduce the risk weights for the general interest rate risk class by 20-40 percent and would reduce risk weights for the equity and foreign exchange ("*FX*") risk classes by 25-50 percent, with no changes proposed for the credit spread and commodity risk classes. The final calibration for risk classes will be based on further data regarding the FRTB's impact and comments on the Consultation.[9]
  - The Consultation would permit banking organizations to combine two currency pairs from the FRTB list of liquid FX currency pairs and treat the resulting FX pair as liquid and, thus, subject to lower capital requirements.
  - The FRTB requires banking organizations to calculate capital requirements with respect to each risk class under a "high correlation," "low correlation" and "medium correlation" scenario. The Consultation would limit the reduction in the "low correlation" scenario to

address a concern that the scenario leads to more conservative correlations than would be supported empirically for risk factors that are consistently highly correlated.

- The FRTB requires a banking organization to calculate curvature risk capital requirements for non-linear instruments based on the maximum loss of an upward shock and a downward shock. In light of concerns that similar or related financial instruments may have capital requirements based on different shocks, the Consultation would apply consistent shocks to risk factors that are defined to be in the same "bucket" for the credit spread, equity and commodity risk classes and seeks comment on an alternative approach that would define "sectors" as a subset of each bucket and apply consistent scenarios at the "sector" level.[10] The Basel Committee also proposes to apply a floor to address cliff effects that may arise when calculating aggregate curvature risk capital requirements.
  - The Basel Committee has observed that double-counting issues may arise when banking organizations hold FX options in which neither of the underlying currencies is the banking organization's reporting currency and seeks comment on the materiality of these issues. The Consultation sets forth a potential revision that would apply a scalar if the Basel Committee determines that the issue is material.
- The Consultation proposes revisions to clarify the treatment of multi-underlying options and index instruments under the Standardized Approach.

- ***Internal Models Approach***. The Consultation would revise the profit and loss attribution test used to determine the eligibility of trading desks for the Internal Models Approach (the "*PLA Test*") and the capital requirements applicable to NMRFs.
  - The PLA Test is intended to assess whether the banking organization's risk management models appropriately measure material risks by comparing its hypothetical profit and loss ("*HPL*") to its risk-theoretical profit and loss ("*RTPL*"). HPL is calculated using the same systems as for determining daily profit and loss with commissions, fees, intraday trading and certain valuation adjustments excluded, and RTPL represents the profit and loss that is calculated when only the risk factors and techniques used in the banking organization's risk management model are included. The Consultation would apply a modified "traffic light" approach for purposes of determining the market risk capital requirements for a trading desk that fails the PLA test, in light of concerns that immediately requiring a trading desk to use the Standardized Approach upon failure of the PLA Test could result in significant volatility in FRTB capital requirements. Specifically, a trading desk in the "amber zone"—representing trading desks that do not meet the PLA Test but would not be required immediately to use the Standardized Approach—would be subject to an additional capital requirement. In contrast, trading desks in the "red zone" would be required to use the Standardized Approach.
    - The Basel Committee indicated that it will monitor the final calibration of the "amber zone" and "red zone" thresholds.
  - While the FRTB calculates PLA Test metrics on a monthly basis using data over the previous one-month period, the Consultation would calculate the PLA test on a quarterly basis using data collected over the preceding 12 months, in order to address concerns that a one-month sample may not be sufficiently representative. The Consultation also proposes two new test metrics for comparing the trading desk HPL and RTPL figures and would clarify that banking organizations may align relevant input data to address concerns that differences between the HPL and RTPL of a trading desk may arise due to acknowledged differences or misalignments in input data.
  - The FRTB would be amended to revise requirements relating to the number of head traders per trading desk and to the assignment of a trader to a single trading desk. These proposed changes are intended to make the FRTB more consistent with the actual organization of trading desks.
  - The FRTB permits a banking organization to include a risk factor in its internal model if it satisfies the risk factor eligibility test (the "*RFET*"), whereas risk factors failing the RFET are

classified as NMRFs, excluded from the expected shortfall calculation and subject to capital requirements on the basis of a stress scenario. In light of concerns with the RFET standard, the Consultation would clarify the meaning of “representative” real price observations and seeks comment on two alternatives to determine the similarity of an observable transaction risk factor to a financial instrument risk factor. The Basel Committee additionally proposes to clarify when committed quotes and data-pooling arrangements could be used in connection with the RFET standard and related principles for calibrating models based on these types of data.

- The Consultation seeks comment on the validity and materiality of concerns raised by market participants that some risk factors may be inappropriately classified as NMRFs due to seasonal factors. The Consultation does not propose any changes in this area, and the Basel Committee notes that it would not make any changes in the absence of “compelling evidence.”
- Banking organizations are permitted to use a single stress scenario and consider diversification with respect to NMRFs associated with idiosyncratic credit spread risk. The Basel Committee noted that some banking organizations have asked that this exception from the general prohibition on using a single stress scenario and recognizing diversification for NMRFs be extended to idiosyncratic equity risk but stated that it has not received sufficient evidence on the materiality of this issue and is seeking further comment on a proposed textual solution and the materiality of the issue, including supporting concrete evidence and data. Here as well, the Consultation provides that the Basel Committee will not make changes in the absence of “compelling evidence.”

- ***Scope***.
  - The Consultation would revise the FRTB to clarify the boundary between the banking book and the trading book when a financial instrument is both on the list of instruments required to be in a particular book and on the list of instruments expected to be in the other book. In addition, the Consultation proposes to clarify that equity investments in funds (such as exchange-traded funds) may be included in the trading book if the funds have daily price quotes available, track a non-leveraged benchmark and demonstrate a tracking difference (ignoring fees and commissions) for which the absolute value is less than one percent.
  - Under the FRTB, “structural FX positions” (*i.e.*, FX positions that hedge a banking organization’s capital ratio) may be exempted from market risk capital requirements up to the maximum of the amount of investments in consolidated subsidiaries or non-consolidated affiliates. The Consultation would permit the exempted amount of structural FX positions to be based instead on the FX risk arising from the investment.
- ***Simplified Alternative to the Standardized Approach***. In contrast to a June 2017 consultative document proposing a simplified alternative to the Standardized Approach based on a scaled back version of the FRTB Standardized Approach, the Consultation proposes to introduce a simplified alternative based on a recalibration of the Basel II Standardized Approach.[11]
  - The simplified alternative would apply a multiplier to the capital requirements in each risk class of the Basel II Standardized Approach, with the final calibration to be determined based on further data analysis and feedback on the Consultation.
  - The Basel Committee noted that the recalibrated simplified alternative is intended to be “slightly more conservative” than the revised Standardized Approach and that the simplicity of the approach may not be appropriate for all banking organizations, including G-SIBs, banking organizations that use internal models to determine market risk capital requirements or banking organizations with correlation trading positions.
- ***Implementation***. The Consultation amends the implementation date for Pillar 3 market risk disclosure requirements to January 1, 2022. The Basel Committee noted that it will assess the

impact of these proposals based on data provided in its December 2017 Basel III monitoring exercise.

OBSERVATIONS

The breadth of changes to the FRTB proposed in the Consultation and the variety of FRTB elements on which the Basel Committee either is seeking comment or considering changes demonstrates that the market risk framework is continuing to develop and the contours of its ultimate implementation in relevant jurisdictions is uncertain. The evolving nature of the market risk framework, in addition to the significant changes to capital requirements introduced in the recent Basel IV release,[12] raises many open questions regarding how the U.S. banking agencies will revise the U.S. regulatory capital framework.

The current U.S. regulatory capital framework generally applies the market risk rules to any banking organization, regardless of size, with aggregate trading assets and trading liabilities equal to 10 percent or more of quarter-end total assets or $1 billion or more.[13] In addition, the U.S. regulatory capital framework does not include a standardized approach for market risk, as only the models-based approach has been implemented in the United States. Accordingly, market risk capital requirements are substantially the same for purposes of the Collins Amendment floor, which compares capital requirements under the U.S. standardized and advanced approaches.[14]

The FRTB and the Consultation contemplate a fundamentally different structure, with the Standardized Approach serving as a floor for the Internal Models Approach, and varying approaches—the Internal Models Approach, the Standardized Approach and the simplified alternative to the Standardized Approach—applying to varying banking organizations. It remains to be seen whether the U.S. banking agencies will revise the applicability thresholds of the U.S. market risk capital rules, introduce non-models based approaches that are applicable to only a subset of U.S. banking organizations, or provide for different measures of market risk capital requirements (based on the Standardized and Internal Models Approaches) to be used in the Collins Amendment floor.[15]

In general, calculations at the trading desk level determine capital requirements under the FRTB. The FRTB provides that banking organizations using the Internal Models Approach can have trading desks that use the Internal Models Approach to calculate capital requirements and others that use only the Standardized Approach to calculate capital requirements. This aspect of the FRTB, combined with the varying approaches that can apply to varying banking organizations, may introduce further complexity into the overall market risk framework. Even for banking organizations that use the Internal Models Approach, the extent to which their trading desks use that approach or the Standardized Approach will vary from institution to institution.

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ENDNOTES

1 Basel Committee, *Consultative Document: Revisions to the Minimum Capital Requirements for Market Risk* (Mar. 2018), *available at* https://www.bis.org/bcbs/publ/d436.pdf.

2 Basel Committee, *Minimum Capital Requirements for Market Risk* (Jan. 2016), *available at* https://www.bis.org/bcbs/publ/d352.pdf.

3 Basel Committee, *Consultative Document: Simplified Alternative to the Standardised Approach to Market Risk Capital Requirements* (June 2017), *available at* https://www.bis.org/bcbs/publ/d408.pdf.

4 Basel Committee, *Basel III: Finalising Post-Crisis Reforms* (Dec. 2017), *available at* https://www.bis.org/bcbs/publ/d424.pdf. For further information about the final Basel III standards, please see our Memorandum to Clients entitled *Bank Capital Requirements: Basel Committee Releases Standards to Finalize Basel III Framework* (Dec. 19, 2017), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_12192017.pdf.

5 Basel Committee, *International Convergence of Capital Measurement and Capital Standards* (June 2006), *available at* https://www.bis.org/publ/bcbs128.pdf. The Basel Committee introduced revisions to its market risk framework prior to implementation of the Basel III standards, which are commonly referred to as "Basel 2.5". Basel Committee, *Revisions to the Basel II Market Risk Framework* (Feb. 2011), *available at* https://www.bis.org/publ/bcbs193.pdf.

6 Basel Committee, *Consultative Document: Fundamental Review of the Trading Book* (May 2012), *available at* https://www.bis.org/publ/bcbs219.pdf; *Consultative Document: Fundamental Review of the Trading Book: A Revised Market Risk Framework* (Oct. 2013), *available at* https://www.bis.org/publ/bcbs265.pdf; *Consultative Document: Fundamental Review of the Trading Book: Outstanding Issues* (Dec. 2014), *available at* https://www.bis.org/bcbs/publ/d305.pdf.

7 With respect to the sensitivities-based method, the risk classes are (i) general interest rate risk; (ii) credit spread risk, non-securitization; (iii) credit spread risk, securitization; (iv) credit spread risk, correlation trading portfolio; (v) foreign exchange risk; (vi) equity risk; and (vii) commodity risk.

8 For the default risk charge, the risk classes are (i) default risk, non-securitization; (ii) default risk, securitization; and (iii) default risk, securitization correlation trading portfolio.

9 The Basel Committee indicated that it may make corresponding changes to the risk weights used pursuant to the standardized approach to credit valuation adjustment risk, given that these risk weights were based upon the prescribed risk weights under the FRTB.

10 As used under the FRTB, a "bucket" is a defined group of risk factors with similar characteristics.

11 *See supra* note 3.

12 *See supra* note 4.

13 *See* 12 C.F.R. §§ 3.201(b) (OCC), 217.201(b) (Federal Reserve Board) and 324.201(b) (FDIC).

14 Section 171 of the Dodd-Frank Act, commonly referred to as the "Collins Amendment," imposes a floor of the generally applicable risk-based and leverage capital requirements under the prompt corrective action framework for U.S. depository institutions on the capital requirements of advanced approaches banking organizations. The U.S. capital rules currently include a floor, the scope and calibration of which differ from the Basel IV output floor.

15 As discussed in our Memorandum to Clients on Basel IV referenced in note 4 above, it is unclear how the Basel IV output floor will operate alongside the Collins Amendment floor.

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