

**Fundamental Review of the Trading Book (FRTB)**  
**An ICMA briefing note**  
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***What is the FRTB?***

The FRTB is a set of proposals by the BCBS (first consulted on in 2012) that will create the framework for the next generation of market risk regulatory capital rules for banks that actively trade in capital markets (it is already being dubbed 'Basel IV'). Areas covered by the new framework will include the definition of the trading book, market risk and liquidity risk measurement and capitalization, and the supervision of the internal risk models.

***What are the key components of the FRTB?***

The measures propose two key changes:

- (i) Standardized criteria for defining **the boundary between the trading and banking book**. This is intended to achieve better alignment in capital quantification across different banks and to eliminate incentives to designate discretionally individual positions across the different books with the intent to minimize capital usage (i.e. 'capital arbitrage').
- (ii) Recalibration of both the standardized approach (SA) and internal risk model (IRM) with the intention of **better aligning capital costs between both the SA and IRM approaches**. This entails:
  - A more sophisticated, granular, and sensitized mechanism for calculating the standardized approach (SA) capital charge, better aligned with the banks' actual risk management practices, which banks will have to maintain alongside their internal risk model (IRM).
  - Three proposed additional components for use of the IRM approach:
    - **Expected Shortfall (ES)** as an alternative market risk metric to VaR. The ES also integrates liquidity risk (liquidity horizons) to reflect the ease of unwinding positions without significant price impacts.
    - **Incremental Default Risk (IDR)**, designed to capitalize the jump to default risk. Significantly, **securitization products are completely disallowed in the IRM treatment**.
    - Capital add-on based on stress-testing and scenario analysis, designed to capture non-modellable risk factors **NMRF**.

Furthermore, the trading book will have to report under both the SA and IRM approaches. For banks to use the IRM, they will need to investigate and assess the current level of consistency between their front-office P&L and their risk management P&L. In the event that these consistency requirements are not met, the SA model will act as a fall-back to the IRM.

### ***Will this increase capital requirements needed to support trading activities?***

While the intention of the proposal was not to increase capital requirements beyond the increases prompted by Basel 2.5/3, it is likely that many firms, particularly those that rely heavily on the IRM approach, will see their requirements increase. While the overall position in regulatory capital requirements is not expected to change dramatically, it is likely that there will be changes across different businesses. Fixed-income is expected to be the most impacted as result of the new trading book definition, the new models-based approach, the incorporation of liquidity risk, and the supervisory risk correlations for hedging and diversification.

### ***What does the quantitative analysis indicate?***

In response to the BCBS QIS consultation in October 2015, analysis by ISDA, GFMA, and IIF, based on data submitted by 28 globally/locally significant banks from June 2015, suggested the following impacts:

- The capital charge of the SA methodology is x4.2 the total market risk capital currently being held by the banks.
- The residual risk add-on charge accounted for 47% of the total increase in the SA requirement.
- Securitization is impacted adversely, with an increased capital requirement of x2.2.

In November 2015, the BCBS published its own QIS 'interim impact analysis' based on the data from 44 banks from December 2014. Key findings are:

- Total non-securitization risk capital charges would increase by only 4.7% of the overall Basel III minimum risk requirement
- When the bank with the largest value of RWA is excluded, this translates to a 2.3% increase
- Compared to the current market risk framework, the proposed framework would result in a weighted average increase of 74% in aggregate market risk capital charges: this is 41% as a simple average, and for the median bank the capital increase is 18%.
- When measured as a simple average, the capital requirement under the current IRM approach is 54% higher. For the median bank this is 13% higher.
- Compared to the current SA framework, the proposed SA framework capital requirement is 128% higher; and 51% higher for the median bank.

Of note, this QIS exercise does not test the capital impact of the proposed standardized approach treatment for all securitization exposures in the trading book. An internal model approach for securitization exposures in the trading book is not provided.

### ***What are the operational implications?***

While the level of impact will vary from bank to bank, it is clear that the regulation will have significant and sweeping implications for trading operating models, processes, systems, and policy frameworks:

- *Risk methodology:* the introduction of ES will mean that firms need to develop and broaden their risk models.
- *Risk policies and procedures:* banks will need to review their market and trading risk under the new models, and devise new policies and control processes.

- *Risk systems and data management:* banks will need to develop systems to maintain both the IRM and SA models, as well as ensuring consistency between the desk and control P&Ls, involving a significant increase in data capture, maintenance, and processing.
- *Resources:* implementation of and compliance with FRTB will require significant human and technological resources.

***What are the timelines for implementation?***

The target date to finalize the FRTB framework is expected to be published by the Basel Trading Book Group (TBG) by the end of 2015. It is expected to 'go live' in Q1 of 2018.

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