

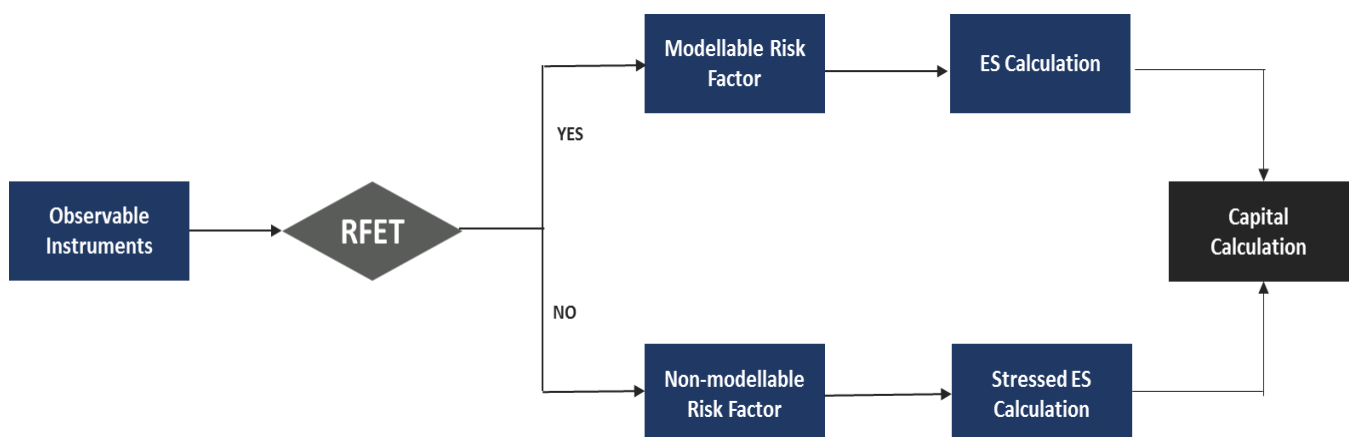
FRTB: THE BCBS'S RESPONSE TO NMRF BURDEN

On the 14th of January 2019, the Basel Committee on Banking Supervision (BCBS) released the final revisions to the Minimum Capital Requirements for Market Risk as part of the Fundamental Review of the Trading Book (FRTB).

The final text has confirmed the extension of the framework's implementation from the original 1st of January 2019 date to 1st of January 2022. Furthermore, the committee has tackled numerous concerns raised by banks in previous FRTB consultation in March 2018. Among those concerns, Non-Modellable Risk Factor (NMRF) was one of the most contentious areas.

As a reminder, Non-modellable risk factors (NMRFs) are all risk factors that have failed the eligibility test to be included in the bank internal capital model.

Overview of the risk factor Modellability test



Source: Aurexia Consulting

REVISED RFET REQUIREMENTS

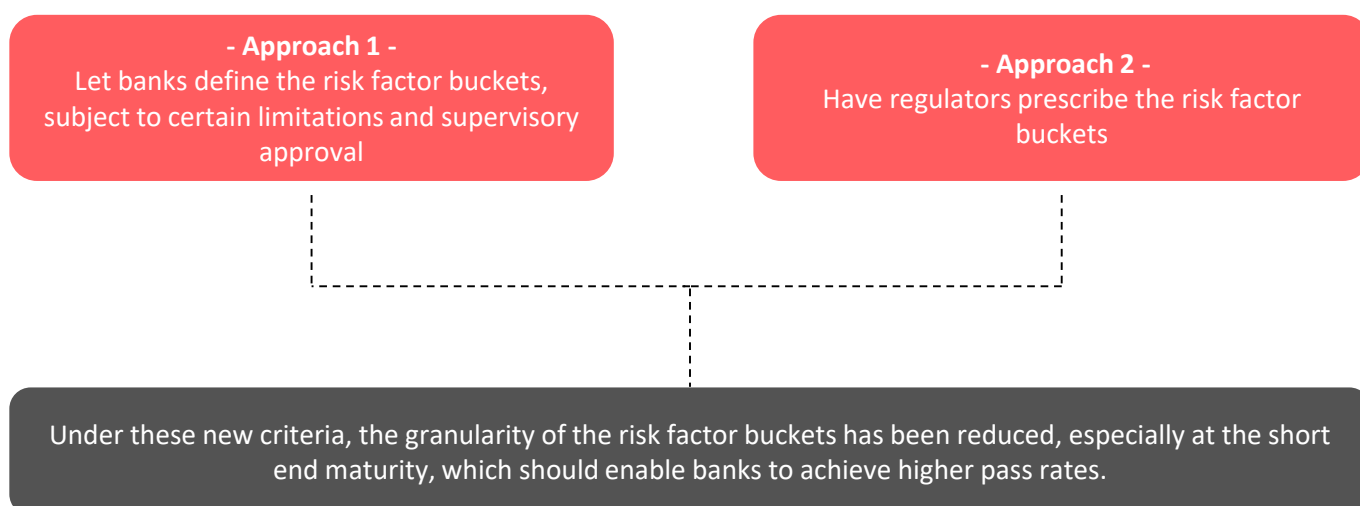
In the final version, the committee has relaxed the modellability criteria for Risk Factor Eligibility Test (RFET), which aims to increase the modellability rates for risk factors falling into IMA capital framework.

Under the original January 2016 rules, banks were required to show that during the previous 12 months they had at least 24 real price observations (RPO) with no more than one month between any two consecutive observations. Banks had taken issue with this, claiming the seasonality of some assets, where some instruments might be flagged as non-modellable due to the trading concentration at a particular time of year. The regulator's response in January 2019 was to amend these observability rules to include risk factors according to the following rules: there must be (a) 24 RPO in the previous 12 months with no 90-day period containing less than 4 observations or (b) 100 real price observations in previous 12 months available, with no more than 1 real price observation per day to be included in this count.

Although, the 90-day gap between 'real' observations will still be the binding constraint, the new gap should enable more risk factors to pass. Also, the new minimum of 100 price observations in previous year will increase the modellability rates, particularly, for newly issued liquid instruments that were deemed non-modellable because they were only observable from a recent start date within previous year.

RISK FACTOR BUCKETING

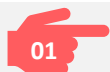
With regards to the bucketing approach – which consists in segmenting continuous market data in order to count as an eligible observation for the purpose of RFE, the BCBS has confirmed 2 approaches:



However, it is important to note that the risk factor granularity has contradictory requirement between NMRP and P&L attribution (PLA), in that defining not enough risk factors can lead to PLA failures, and hence IMA ineligibility while enabling higher modelability rates for risk factors.

DATA SOURCE AND TRANSPARENCY

Under the revised rules, banks will be allowed to use internally executed trade and committed quotes. Banks will also be able to complement their observation set with 'real' observation data from third-parties if the following conditions are met:



The vendor communicates to the bank the number of corresponding real prices observed and the dates at which they have been observed



The vendor provides, individually, a set of minimum necessary identifier information to enable banks to map real prices observed to risk factors



The vendor is subject to an audit regarding the validity of its pricing information

Finally, the regulator confirms that collateral reconciliations or valuations cannot be considered real prices to meet the RFET.

CAPITAL CALCULATION

The January 2016 framework required banks to identify a separate stress period for each NMRF for the calculation of stressed loss. The amended 2019 framework allows banks to use a common stress period for all risk factors relevant to a particular risk class (e.g. all interest rate risk factors). Also, for each NMRF, the liquidity horizon of the stress scenario must be the greatest of the liquidity horizon assigned to the risk factor specified for the Expected Shortfall, with a floor of 20 days.

Finally, the aggregation approach to calculating the overall NMRF capital requirement will incorporate additional, but limited, diversification benefits; Zero correlation for credit spreads and equity idiosyncratic risks and 60% across other NMRFs. Impact assessment of the new amendments to the framework provided in the revised BCBS's paper is estimated to result in a reduction of 60 % of the amount of NMRF capital requirements.

CONCLUSION

Overall, the Basel revisions under RFET help increase modellability rates, but it's fair to say that the implementation challenges will remain. New data governance and controls should be in place to oversee the process of identifying 'real' price transaction data to ensure completeness and accuracy. Also, banks will need to implement comprehensive data management processes and work with data vendors to develop new standards around 'real' data observation.

Finally, while designing the new FRTB framework, banks should take a holistic view of their other interdependent initiatives and programs such as the Targeted Review of Internal Models (TRIM), IBOR Transition and stress testing to facilitate budget allocation, resourcing and governance across systems and processes.