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April 2017

FRTB: Implementation Challenges

Inconsistent jurisdictional timelines and unresolved rules make the implementation of FRTB challenging for banks facing increased cost pressures

Basel Committee on Banking Supervision (BCBS) published the final rules for the Fundamental Review of the Trading Book (FRTB) in January 2016. FRTB rules are intended to harmonise the treatment of market risk across national jurisdictions and to ensure that trading book capital requirement approaches are better aligned with the trading book's underlying risk.

These reforms come on top of other significant mandates and will further complicate banks' efforts to pursue an appropriate business strategy under the new capital requirements.

Banks are struggling to implement the new FRTB rule book due to considerable uncertainties on multiple fronts. The statements by the new US administration that they are unwilling to adopt new regulations from the BCBS calls into doubt if the US will adopt FRTB.

Broadly, Donald Trump campaigned on reducing regulation, and this emphasis continues. If the US rejects -fully or partially- FRTB then it is unclear how other jurisdictions will respond. Will they plough ahead and adopt the full FRTB framework or implement a watered down version? What is clear is that the Basel objective of having comparable capital frameworks for banks will be in jeopardy. The European proposal for new regulations Capital Requirements Regulation 2 (CRR2) already include EU specific variation.

However, this is not the only uncertainty facing banks. Even if the FRTB rule book is adopted globally there are still key issues with the framework itself which as yet are unresolved. Model eligibility, a collection of tests that determine whether a bank will use the internal model approach (IMA) or the standardised approach (SA) are yet to be defined with sufficient precision to be workable. So, as yet, the full capital implications have not been calculated.

The capital volatility which could materialise if the eligibility tests prove to be unstable may create significant complexity and uncertainty making business planning challenging. Specifically, the eligibility tests will impact banks' desk set-up and if the capital measure proves to be unstable enough it may result in Pillar II capital buffers to capitalise the worst case outcome.

In addition, the identification and capitalisation of non modellable risk factors (NMRF) may result in the internal model capital charge being similar to, or even greater than the standardised charge for some businesses, in which case the investment in internal models may not yield any material benefits.

Multijurisdictional implementation challenges and the shift to a more complex Expected Shortfall (ES) calculation are some other key considerations.

These uncertainties leave banks in the unenviable position of needing to invest considerable amounts in internal models now in order to be compliant by the go live date- January 2019- but not clear on whether the investment will ultimately prove worthwhile or even necessary.

From an overall state of the industry perspective every bank has its own unique set of FRTB strategic and implementation challenges, and regulatory deadlines to meet – at the very least it's clear that all need to be focused now on ensuring that Standard Rules will be implemented to meet their local regulatory deadline. In addition we recommend that banks undertake comprehensive assessment to see the capital impacts in order to assess if IMA is worthwhile under hard/easy eligibility scenarios, and to assess whether IMA is worth pursuing. As part of this they should also ensure they fully understand the impacts of NMRF on this.

Banks need to ensure that they have in place sufficiently strong analytical capabilities to calculate possible capital scenarios at business level globally and across legal entities, in order to inform the project and change management functions and enable the efficient allocation of sparse resources. These capabilities can then provide, substantial support in the formulation of the most optimal business model under the new regulations.