



FUNDAMENTAL REVIEW OF THE TRADING BOOK (FRTB)

Revolution, Not Evolution

The Basel Committee on Banking Supervision issued a revised market risk capital framework in January 2019 with the scheduled implementation date set for January 2022. These revolutionary changes demand careful consideration from banks which must prepare ahead in order to effectively navigate these complex requirements.

Major changes to Basel II.5 include:

- The establishment of a more objective boundary between the Banking Book and Trading Book with explicit requirements for inclusions/exclusions to each.
- An overhaul of the Internal Models Approach (IMA) by introducing a more rigorous model-approval process at the Trading Desk level and mandating that Trading Desks which cannot obtain regulatory approval must use the Standardized Approach (SA).
- An overhaul of the SA by making it more risk-sensitive to reduce the gap between internal models and standard rules.
- A shift from VAR to Expected Shortfall, as the new industry standard when using the IMA, in order to capture the tail risk and capital requirements during periods of high financial stress, which the VAR failed to do.
- The incorporation of varying liquidity horizons into the revised SA and IMA approaches and the IMA replacing the incremental risk charge with an incremental default risk model.

Background

The Fundamental Review of the Trading Book (FRTB) is a comprehensive suite of capital rules developed by the Basel Committee on Banking Supervision (BCBS) as part of Basel III, intended to address the shortcomings of the existing Basel II.5 framework on capital requirements that were exposed during the 2007-2008 financial crisis. The new market risk capital framework was released on January 12, 2016, and originally scheduled to be implemented as final rules under domestic legislation on 1 January 2019, with a go-live date on 31 December 2019 for regulatory reporting for financial institutions. However, in December 2017, following many concerns raised by the banking industry, the BCBS extended the implementation date to January 2022, and issued a revised framework in January 2019.

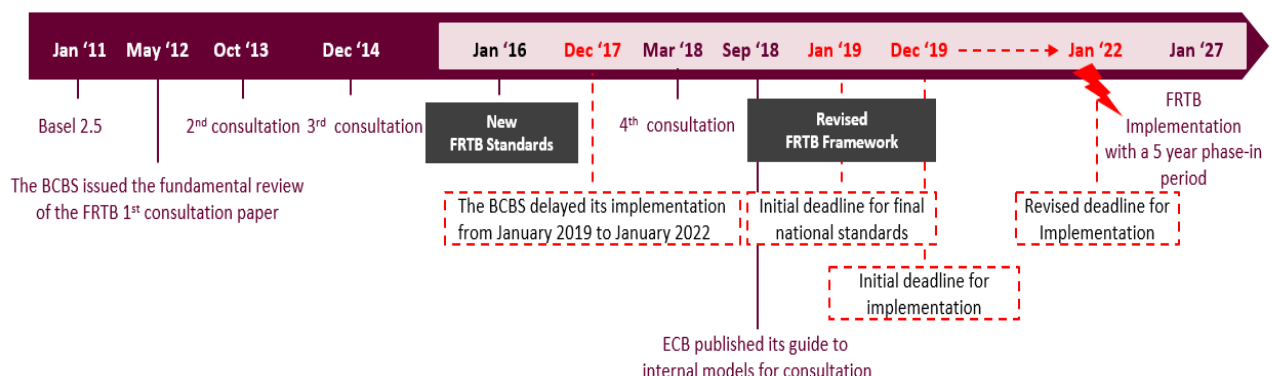
Each jurisdiction must produce its own version of FRTB (national standards). Domestic legislation has not been defined yet. The rules from the Federal Reserve are expected to be issued later in 2019.

Summary of new changes:

- Clarifications on the scope of exposures that are subject to market risk capital requirements.
- A simplified SA for use by banks that have small or non-complex trading portfolios.
- Refined SA treatments of foreign exchange risk and index instruments.
- Revised SA risk weights applicable to general interest rate risk, foreign exchange and certain exposures subject to credit spread risk.
- Revisions to the assessment process to determine whether a bank's internal risk management models appropriately reflect the risks of individual trading desks.
- Revisions to the requirements for identification of risk factors that are eligible for internal modelling (IMA).

What to Expect Going Forward

Regulatory Updates and Timeline



The revised framework is estimated to result in a weighted average increase of about 22% in total market risk capital requirements relative to the Basel II.5 framework. By contrast, the framework issued in 2016 would have resulted in a weighted average increase of about 40%. Other estimates are much higher, with some banks expecting over 100%, and if they use the SA, 2 to 6 times as much capital as the IMA.

The new FRTB regulations will have a profound impact on Trading Desks in particular. Some of the resulting effects include:

- A **major increase in regulatory capital**, particularly for illiquid instruments, requiring significant changes in business strategy and Trading Desk mandates.
- A **rebuild of all trading and regulatory risk management systems**, and requirement for consistency of models, calculations and results between trading and regulatory.
- A requirement to hold and manage **huge amounts of market data**.
- **High costs of implementation, and high ongoing costs of management**, control and surveillance of data, risk calculations, and Trading Desk results.

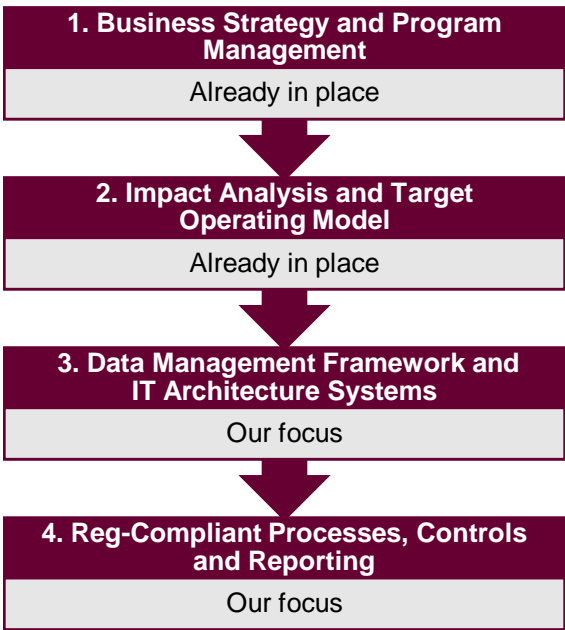
The FRTB changes are revolutionary, not evolutionary. They represent tremendous challenges beyond Risk departments with an impact on Front Office business practices through higher capital charges.



The new FRTB standards are transformational and require organizational changes within banks. While the final requirements are manageable, the problem is that only 44% of global banks surveyed by IHS Markit in October 2018 stated that they expected to be fully ready to implement FRTB by 2022.

How Sia Partners Can Help

Sia Partners has been actively assisting clients with planning and execution of FRTB, including end to end impact assessment, project management office, gap reviews, data architecture, data management, target state business and technology architecture, detailed design, implementation assistance and policy/procedure authoring. Our offering includes the following four key steps to successfully prepare for FRTB implementation.



1. Business Strategy and Program Management

- Support our clients in their **business strategies** development and define the FRTB implementation approach.
- Establish a **Project Management Office**, leveraging on the existing project governance structure to manage the Program financials, Risks, Assumptions, Issues, Dependencies (RAID) logs, communication and change management.
- Jointly with Bank SME's, conduct numerous **workshops** with Bank front office, technology, data management, risk management and regulatory experts to understand current state, identify major gaps versus FRTB requirements, and develop potential solutions.

2. Impact Analysis and Target Operating Model

- Conduct deep dives, workshops, and detailed analyses on Trading Desks, products, business/functions, data architecture, risk management and regulatory systems, and regulatory capital.
- Determine **data requirements** to support processes such as P&L Attribution, Back Testing, and Risk Factor Effectiveness Tests, and new capital requirement computation methodologies, including the identification of NMRF's.
- Quantify volumes of data required and develop approaches to manage, control and ensure consistency end to end.
- Develop high level **Future State organization, business, technology and data architecture, flows and roadmap**.

3. Data Management Framework and IT Architecture Systems

- Build a comprehensive **Data Architecture** framework on which the client is building technology and business solutions to manage and control the large amounts of data required for FRTB.
- Establish and drive **governance process** to ensure that technology architects for Risk, Finance, Reference Data, Capital Markets and other impacted teams jointly review potential solutions to achieve the technical and functional target state.
- Define **Data Architect project artifacts and templates**, establish tracking systems, connect artifacts and templates to original FRTB requirements, with capability for continuous update as requirements changed.
- Ensure **timely delivery** of FRTB Data Architecture related deliverables, and report end to end program level milestones to Senior Management.

4. Reg-Compliant Processes, Controls and Reporting

- Define internal **policies and processes** to monitor compliance with Trading Book boundary rules.
- Conduct a **governance and process review**, change governance structures to provide model approval at Trading Desk-level and actively involve the Board of directors and senior management in the risk control process.
- Define **human resources** needs in line with organizational choices.
- Implementing **controls framework** by establishing a control repository to ensure compliance with the regulatory framework
- Implement **reporting requirements** (to senior management and regulators), including: Desk structure, Instrument types, Policies for designation as internal model, Exceptions to the general presumptions, Desks on SA, etc...

The Bottom Line

The new FRTB requirements are extremely complex and will force banks to make major organizational changes in order to effectively operate in accordance with the rules. Most banks have already started to:

- Develop a detailed understanding of the requirements and implications of FRTB.
- Conduct a complete review of their trading books and the existing infrastructure capabilities.
- Determine necessary design and technology changes.
- Assess the impacts on regulatory capital requirements.
- Define program governance and execution plans.

The revised global market risk framework published in January 2019 is the finalization of numerous modifications that have been proposed and evaluated following the 2007-2008 financial crisis. The FRTB changes are revolutionary, not evolutionary. These transformational standards will result in both expected and unexpected challenges for banks. Despite the fact that the exact FRTB national standards have not been announced in all jurisdictions yet, **no bank should wait to prepare for navigating these new capital requirements for market risk**. Even though many firms still have questions about the final domestic legislation that will apply to them, they must start to think about their plans and processes for approaching FRTB now.

Sia Partners has experience in helping banks effectively prepare for the implementation of the new FRTB standards and can use our in-depth understanding on the implications of FRTB requirements to help your bank successfully plan for these changes.

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