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Simplified Standardised Approach: 5 takeaways

Looking at R-SbM, Basel's new FRTB facilitation

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On June 29, 2017, the Basel Committee on Banking Supervision (BCBS) published the first draft of its new Simplified Standardised Approach for market risk capital requirements, also known as the Fundamental Review of the Trading Book (FRTB).

The FRTB market risk capital requirements were finalised in January 2016 and already include a Standardised Approach. However, due to its complexity, the Standardised Approach presents considerable implementation challenges for smaller banks. Therefore, BCBS has now proposed a Simplified Standardised Approach, called the 'reduced sensitivities-based method' or R-SbM. Smaller banks can use this as an alternative.

The first draft of R-SbM is a consultative document that sets out the eligibility criteria and procedures to calculate market risk capital. The consultation period lasts until September 27, 2017, during which feedback is invited from market participants. All comments will be published on the BCBS website unless the market participants request otherwise.

So what's the impact of R-SbM? We take a look:

1 The new approach is operationally simpler…	• The primary component of the Standardised Approach for market-risk capital requirements is called the 'sensitivities-based method' (SbM), which requires banks to categorise risks into several buckets operationally. This is too complex a task for the IT infrastructures of many smaller banks. • The new R-SbM approach relaxes these requirements by using a simplified structure with a much smaller number of risk buckets. For example, for interest rate risk, SbM specifies 10 maturity buckets starting at 3 months and going up to 30 years. By contrast, R-SbM only has 2 maturity buckets – up to 5 years, and more than 5 years. • R-SbM also allows banks to ignore Gamma and Vega risks arising from the use of traded options. Instead, only Delta risks are included. Again, this reduces the operational requirements of banks eligible to use R-SbM.
2 …but leads to higher capital requirements for smaller banks	• Although it comes with greater operational simplicity, the weights used to calculate market risk capital are considerably higher in R-SbM. For example, bonds issued by financial companies carry 10% risk weight, or twice that suggested under SbM. • In general, R-SbM risk weights are up to 10 times higher than those for SbM. This leads to a clear trade-off for smaller banks: while the price of greater operational simplicity is higher capital requirements, the alternative, under SbM, is prohibitive IT infrastructure cost. • Ignoring Gamma and Vega risks could potentially lead to lower capital requirements. However, smaller banks are unlikely to have substantial exposures to these types of risks from traded options and, additionally, the BCBS have set up extra controls around this *(see qualitative requirements on the following page).*
3 Reference data still remains an unresolved challenge	• To implement either SbM or R-SbM, large amounts of static reference data will need to be stored and maintained by all banks. For example, the credit rating of each issuer is required for corporate bonds, while the size of each issuer's market capitalisation is required for equities. • Although the R-SbM approach simplifies other parts of market risk calculation, it does not help banks much in terms of reducing the size of the tasks required to collect and maintain such reference data. From CRISIL's experience, in practice these tasks tend to be operationally complex because the reference data often need to be sourced and transferred across multiple IT systems.

4 Other aspects of the Standardised Approach remain unchanged	• SbM is one of the three components within the Standardised Approach used to calculate market risk capital. The other two are the Default Risk Charge (DRC) and the Residual Risk (RR) add-on for exotic options. • Although the use of R-SbM will allow smaller banks to avoid the operationally complex SbM, they will still have to calculate DRC and RR. In practice, however, these calculations are relatively simple. Also, smaller banks are unlikely to trade in exotic options, so may not have to calculate RR.
5 There are stringent requirements to ensure that only smaller banks use the new approach	• BCBS has made it clear that the R-SbM approach is only intended for smaller banks and banks with a low concentration of trading book activity. To ensure this is the case, several quantitative and qualitative criteria must be met by a bank in order to get the permission to use R-SbM. • The main quantitative criteria for a bank to use R-SbM are: – It must not be a systemically important bank globally (G-SIB) or domestically (D-SIB). – Its total trading book assets and liabilities must be less than €1 billion. – Its market risk-weighted assets must be less than 5% of its total risk-weighted assets. • Qualitative requirements forbid correlation trading and option writing (although buying options is permitted). Banks using R-SbM are required to do so for all trading desks. Partial use of both R-SbM and SBM is not permitted. • In practice, it is expected that these criteria will achieve the objective of BCBS to limit the use of R-SbM to smaller banks.

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