The Basel Committee trading book proposals

- Our initial analysis of the Basel Committee's 3-May-12 consultative document suggests that the most stringent application of all proposals could increase risk-weighted assets (RWA) at CIB units of banks we cover by as much as 23%.
- We approve of 'trading evidence'-based boundary and stressed calibration proposals. The proposals on liquidity risk modelling, however, appear overly complex and could introduce feedback that would lead to chaotic behaviour during a crisis.
- While some options for 'regulatory arbitrage' would be closed, tight(er) focus on the composition of banking and trading books could create a market worth $800m as banks seek to restructure trading risks with financial institutions that have greater capacity to manage them.
- Many of the proposals are well thought out, but the framework still focuses on individual banks rather than the overall financial markets 'ecosystem'. The value of monitoring daily P&L trends is also overlooked. We regard both these omissions as flaws.
- Data from the Committee exposes the fallacy of the 'Volcker Rule' as prop trading is shown to have been responsible for less than 4% of losses during the 2007-09 crisis.

Background

On 3-May-12, Basel Committee on Banking Supervision published 'Fundamental review of the trading book' consultative document. As part of our dynamic product-level analysis of risk-weighted assets (RWA) and value-at-risk (VaR), we present our initial analysis of the proposals and their potential impact on the capital markets/CIB units of top global investment banks we cover.

The trading book/banking book boundary

The Committee rightly acknowledges that its present definition of trading/banking books – largely based on a very subjective 'intent to trade' – was a source of confusion and, more significantly, classification arbitrage. The Committee is now putting forward two options:

- A 'trading evidence'-based boundary that would combine a bank's own classification of intent with the evidence of the bank's ability to trade the instrument *and* actively manage the associated risk. The proposal further envisages the obligatory mark-to-market on daily basis, recognised in the P&L account, and tight(er) regulation governing the switch between the boundaries.

  We regard this proposal as a sensible improvement over the present approach. 'Trading evidence'-based boundary may not be entirely arbitrage-proof and it may require an additional review of banking books capital requirements; but it links *intended* activity to the appropriate form of risk management, while avoiding the danger of overly prescriptive regulation.
- By contrast, a valuation-based boundary would extend the trading book requirements to all financial instruments held at fair-value designation unless it can be proven that they are true hedges to risks in the banking book. Clearly, this approach is far broader in scope than 'trading evidence'-based boundary, so the Committee also proposed exclusions where it can be demonstrated that such activities are used to hedge the banking book.

  The full implementation of this approach would likely impact banks' principal investments units, where assets are often held, at fair value, in the banking book. For some banks, this approach could mean up to 70% increase in the newly-designated 'trading book' assets; the overall implications are difficult to model, given the opacity of many principal investments units' portfolios, but our initial analysis suggests that banks with an equity bias in their principal investment portfolios could see an increase in RWA by 6-8%, while those with a debt focus might even see RWA fall by as much as 11% (due to netting, business refocusing and the differences in the market risk approach).

The full implementation of either approach may disadvantage smaller regional and national banks, and new entrants: these players typically have less sophisticated risk management systems and may find themselves unable to fully meet new standards. We expect that this will lead to some rebalancing activity and hence revenue opportunity for the global investment banks (see below).

Stressed calibration

Extending the risk modelling enhancements introduced in Basel 2.5 – including 'stressed VaR' - the Committee proposes a move to risk measurement based on Expected Shortfall (ES); unlike traditional VaR, ES would specifically target 'tail risk'. The Committee further envisages that risk models should be calibrated to stressed – rather than 'normal' - market conditions, and that ES should be (very sensibly, in our view) back-tested against actual losses (see also section on treatment of hedging and diversification below).

To estimate the impact of this proposal, we compared historical reported daily VaR against the actual reported daily trading losses for a sample of 'our' banks over selected periods; the result suggest that a number of 'our' banks may see their RWA usage rise by 7-10%.

Market illiquidity

The Committee believes that market illiquidity should be better reflected in risk measures and capital usage, and offers a number of ideas based on the introduction of varying liquidity horizons within the regulatory market risk metric and holding of additional capital against jumps in liquidity premia. The Committee appears all too aware that many of its ideas may prove complex to implement and even more difficult to enforce on an ongoing basis – as do we. For example, one idea is to group instruments under standardized liquidity 'buckets'. But how would this be done? And how often? If, for example, sovereign bonds were to be one such bucket, what liquidity premium would they attract? The Eurozone crisis has shown that liquidity for some sovereign debt can all but vanish, but surely that should not mean that all sovereign bonds should have a high premium all the time.

Dynamic models that reflect evolving market conditions (an option the Committee are considering) may not solve this issue either, for the very use of 'buckets' could encourage contagion to spread as a drop in liquidity of one instrument would affect others in the bucket. We return to this issue of unintended feedback loops below.

In our view, an effective approach might be to move risk models away from mid-pricing, and instead use bid prices for long positions and offer prices for short positions. This would not only capture some measure of liquidity (through the bid-offer spread) but would also focus on the potential cost of unwinding a position.

Treatment of hedging and diversification

The Committee has also considered the treatment of hedging and diversification benefits in both the internal models-based approach used by the more sophisticated banks, and the standardised approach open to all. In a nutshell, the Committee's new proposals seek better correlation modelling in the standardised approach - including backtesting the actual capital requirements at a trading desk-level - and using that as a base/surcharge to the models-based approach.

At present, diversification reduces the total VaR at 'our' global investment banks by 30-50%. However, although they are big users of the models-based approach, we do not expect the proposal to have too great an impact over and above that already seen from the proposals on stressed calibration (set out above). We therefore forecast an additional increase in RWA of only 2-5%.

The appropriate treatment of credit instruments

The Committee notes that credit instruments comprise both default/migration risk and credit spread risk, and considers whether it would be possible to combine the default/migration risk in the ES calculation. At present, details in the consultative document are insufficient to allow modelling of the possible impact on banks.

Tricumen initial analysis of the potential impact of the proposals: Summary

Proposals	Impact on CIB RWA
Trading / Banking book boundary	-11% to +8%
Stressed calibration	up 7-10%
Market illiquidity	unknown
Treatment of hedging and diversification	up 2-5%
Treatment of credit instruments	unknown

Source: Tricumen

Regulatory arbitrage

The Committee acknowledges that the regulatory arbitrage has been one of the key weaknesses in the design and the enforcement of the current framework. To an extent, new proposals may help in this respect, though we expect that any significant regulatory, accounting and tax rules differences will offer arbitrage opportunities.

One theme that we draw from the overall thrust of the proposals is that (1) banks will require increasingly sophisticated risk management monitoring and reporting systems for their trading books; and (2) some fair value positions in the banking book that have to date not received much regulatory attention will now be examined in great detail.

For national and regional banks, these trends could lead to increased expense on risk management technology systems and higher RWA usage, the combination of which would lead to lower returns on equity (RoE). We believe this could present an opportunity for global investment banks that offer solutions to these challenges: our analysis of revenue that 'our' top investment banks currently derive from 'bank clients' and the RoE economics suggests that this new market could, in the medium term, yield as much as $800m in annual revenue.

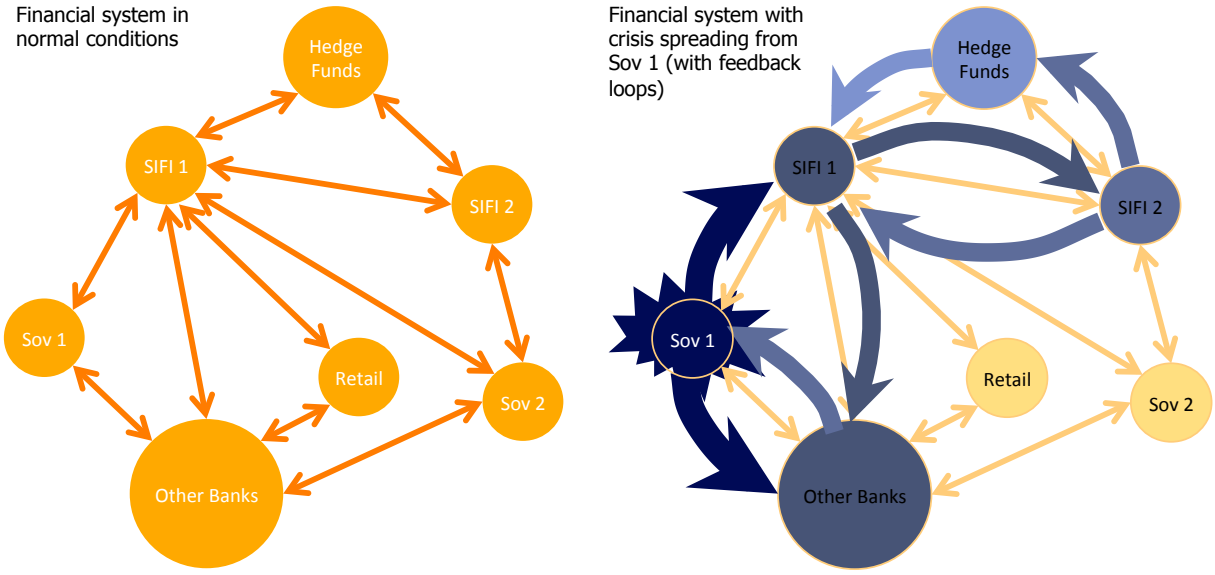
Monitoring the financial markets

In our view:

- Regulators have been too focused on monitoring individual participants, rather than the financial markets as a system;
- There is no substitute for intelligent analysis of day-to-day P&L accounts, especially where it relates to products generating significant revenue;
- Proprietary trading losses accounted for less than 4% of total losses incurred during the Credit Crunch; the full 'Volcker Rule' would not have prevented the last crisis, never mind the next one.

The first issue was highlighted by Andrew G Haldane (Executive Director for Financial Stability, Bank of England) and Robert M May (Zoology Department, Oxford University) in their 'Systemic risk in banking ecosystems' paper, published in Nature on 20-Jan-11. While we do not agree with all of their conclusions, we do agree that regulators should look at the markets as an 'ecosystem' where feedback loops may induce chaotic behaviour, and that there is a positive link between increased efficiency in the financial markets and the corresponding increase in the vulnerability of those markets.

Conceptual representation of a simplified financial system showing feedback loops

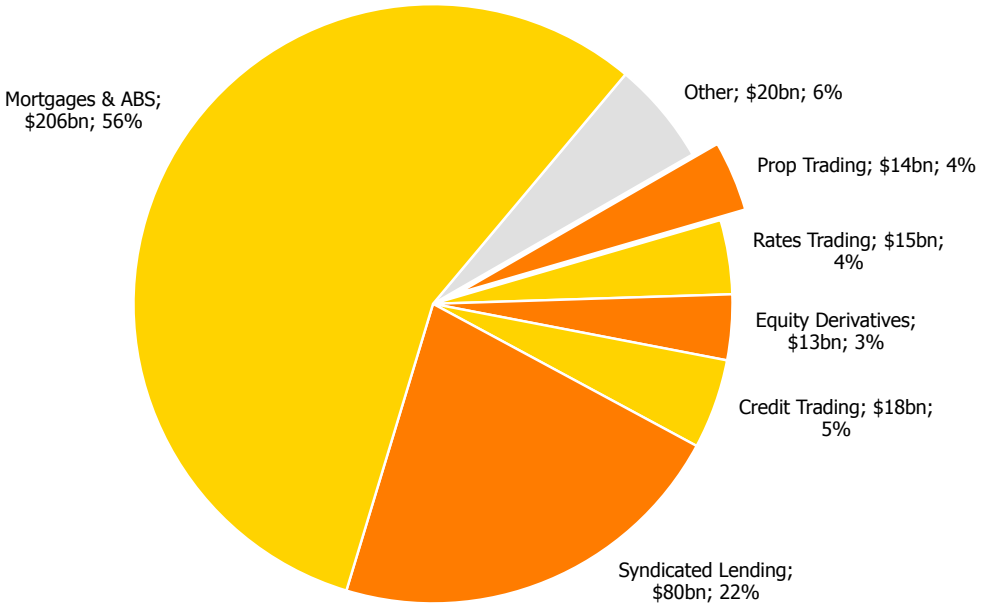


Abbreviations used as follows: 'Sov' – Sovereign; 'SIFI' – Significantly important financial institution, 'Retail' – Retail clients
Source: Tricumen

Secondly, Credit Suisse and Goldman Sachs offer great examples of the intelligent risk management. Both had significant trading exposure to the mortgage market in run-up to the 2007-08 crisis; but both proactively reduced their exposures after noticing small day-to-day P&L losses in supposedly upbeat markets, and thus avoided significant losses.

Finally, the Committee's document contains a section on lessons from the 2007-08 crisis, which draws on quantitative data collected from selection of five US banks and 10 domestic and foreign banks operating in the UK, and qualitative data from other jurisdictions. It will come as no surprise to the opponents of 'Volcker Rule' – and that includes us – that of the total $365bn losses recorded by these 15 US and UK-based banks during Jan-07 – Mar-09, only $14bn or 3.8% related to prop trading.

Losses sustained during the 'Credit Crunch', by business line
(5 US banks and 10 banks operating in the UK, Jan-07 – Mar-09, US$bn)



Source: BIS, Tricumen reclassification and definitions

Notes & Caveats

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