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BASEL COMMITTEE UNDERTAKING REVIEW OF BANK TRADING BOOK CAPITAL REQUIREMENTS

On May 3, 2012, the Basel Committee on Banking Supervision (the "Committee") published its consultative document outlining the Committee's ongoing fundamental review of the regulatory capital standards for bank trading books. Spurred by recent examples of insufficient capital buffers covering bank trading activities, bank regulators are increasingly focused on the market risks that might impact a bank's trading book. While it may have been securitizations, structured credit products and other "toxic assets" that proved the most problematic during the recent financial crisis, the consultative document is meant to cover a wider range of bank trading assets and activities. Assets designated to the trading book, such as syndicated bank loans, other fixed income products, equities, currencies and commodities, for example, will also likely be impacted by the ultimate capital rules.

According to the Committee, the financial crisis exposed several fundamental weaknesses with the current capital rules as they relate to assets held in banks' trading books. Among the weaknesses cited by the Committee is the assumption, now proven to be suspect, that assets designated to a trading book were highly liquid and could be exited or hedged in a short time period. The market illiquidity evident during the financial crisis exposed the weakness of such an assumption, at least when applied on an overly broad basis. Based on an assumption of deep liquidity and short hold periods, the argument goes, current capital rules led to insufficient capital buffers for these to-be-traded assets. Through the consultative document, the Committee sets out the early thinking of global regulators with respect to reforming the capital regime for trading book exposures to address the foregoing and other

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supposed weaknesses of the current regime. While describing certain broad initial policy proposals, the consultative document specifies the following key areas of focus for the Committee's ongoing review:

- **The trading book/banking book boundary:** The Committee has noted that the regulatory boundary between what constitutes a bank's trading book versus its bank book has been a source of weakness in the regulatory regime. Traditionally the key determinant of the boundary has been whether or not the bank intends to trade the asset. However, the focus on intent is viewed by many as overly subjective and subject to regulatory arbitrage. While retaining the basic emphasis on intent for practical reasons, the Committee is proposing two alternative approaches for setting the trading book/banking book boundary: the "trading evidence"-based boundary and the valuation-based boundary. The former approach is characterized by its focus on not only a bank's intent but also evidence of a bank's ability, through its trading desk, to trade and otherwise manage risk of the instrument. This approach would also place tighter controls on a bank's ability to shift instruments back and forth across the boundary. The latter approach, the valuation-based boundary, would be characterized not by intent at all but rather according to the deeper risks that a particular instrument, and particularly any changes in such instrument's fair value, would pose to the institution's regulatory and accounting solvency.

- **Stressed calibration:** In recognition of the widely accepted benefit of countercyclical capital buffers, the Committee notes its intention to calibrate trading book-related capital requirements to periods of significant financial stress whether such stress is indicated by internally generated risk models or the standardized approaches under the Basel framework.

- **Moving from VaR to expected shortfall:** The Committee proposes to move from a regulatory regime that relies on value-at-risk methodology as a basis for setting risk-weighted capital levels to a standardized regime that instead relies on the "expected shortfall" methodology. In making such a proposal, the Committee notes several weaknesses in the VaR approach, including an inability of VaR to confidently capture "tail risk." The expected shortfall method is viewed as being better able to track the tail risk. In particular, the consultative document notes that the expected shortfall approach measures the riskiness of a position by considering both the size and the likelihood of losses above a certain confidence level.

- **A comprehensive incorporation of the risk of market illiquidity:** In a nod to the fundamental role that market illiquidity played in the financial crisis, the Committee's proposed approach is to more comprehensively incorporate market liquidity risk into the setting of regulatory capital levels. In particular, the Committee's proposed approach to measuring market liquidity risk includes the following three elements:

    1. requiring formal assessment of "liquidity horizons" (defined as the time required to exit or hedge a risk position in a stressed market environment without materially affecting market prices). The Committee envisions five liquidity horizons ranging from 10 days on the short end to one year on the longer end;

    2. incorporating varying liquidity horizons in the regulatory market risk metric to capitalize the risk that banks might be unable to exit or hedge positions over a short time period; and

    3. incorporating enhanced capital requirements in connection with jumps in liquidity premia for trading book assets, which capital enhancements would be triggered only upon meeting certain specified criteria; the Committee notes that such criteria would need to take into account any heightened illiquidity in respect of particular trading book assets as well overall solvency risk that could arise from large fluctuations in liquidity premia.

- **Treatment of hedging and diversification:** The Committee is proposing to tighten the latitude banks currently have in recognizing the risk-reducing benefits of hedging and diversification. The Committee notes its concern that banks' internal modeling may significantly overestimate portfolio diversification benefits that do not materialize in periods of stress. Therefore, the Committee is proposing to more closely align the treatment of hedging and diversification between the standardized Basel approach, which strictly limits the recognition of benefits from hedging and diversification, and the more permissive discretion given to banks under the internal model-based approach.

- **Relationship between internal models-based and standardized approaches:** The Committee notes its belief that the current regulatory capital framework for the trading book is overly reliant on private views of risk (i.e., banks' internal risk models) and that variances between such private views and the views embodied in standardized approaches to risk can become quite large. In an effort to strengthen the link between the models-based and standardized approaches, the Committee is proposing to revise both the models-based approach and the standardized approach. In revising the models-based approach, rather than continuing to focus on an institution's entire trading book, the Committee is proposing to hone in on an institution's various trading desks to analyze and verify the efficacy of the internal risk modeling utilized by each such trading desk. By proposing the introduction of quantitative tools aimed at (i) measuring how well a trading desk's risk management model captures risk factors that drive the desk's profit and loss and (ii) backtesting the performance of such risk management models, the Committee is proposing a much more granular assessment of how trading book capital levels are being calculated across any particular institution. Under this approach, any trading desk that performs these tests unsatisfactorily would not be eligible to use internal models to set capital levels and would instead be required to use the standardized Basel approach for calculation of risk-weighted capital.

  In turning to the standardized approach, the document notes an intent to make such approach more risk-sensitive and enhance its credibility as a fallback to internal modeling. In particular, the Committee proposes the incorporation of a "partial risk factor" approach as the revised standardized approach. This approach would assign assets to one of 5 risk classes (i.e., interest rates, equities, credit (including securitizations), FX and commodities) and then one of approximately 20 "buckets" within each of the five risk classes. Risk weights for each bucket would be predetermined by regulatory body and used to calculate applicable capital charges. Lastly, the risk measures of individual buckets would be aggregated to obtain the capital requirement for the trading book. The document also outlines a "fuller risk factor" approach which, instead of assigning assets to prescribed risk classes and buckets, would assign a set of prescribed risk factors and associated risk factor "shocks" on an asset-level basis to determine the size of risk positions and then set the trading book capital charge by subjecting the aggregate risk position to a prescribed regulatory algorithm.

The consultative document is now out for public comment through September 2012, at which time the Committee will commence the formulation of more detailed proposals next year for further industry feedback. The changes are unlikely to be implemented any time before 2015. Although it may be some time before any new trading book capital rules are implemented, the Committee's consultative document provides helpful indications of the direction the process may be headed.

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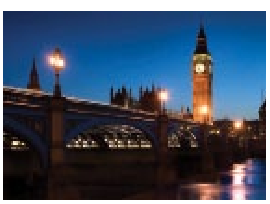

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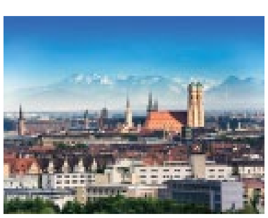

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