With the implementation less than two years away, it is imperative that jurisdictions finalise the interpretation of the Fundamental Review of the Trading Book (FRTB) rules locally, and banks take action soon to address the many remaining challenges to ensure full compliance.

Europe is by far the only region that has done much work in its preparation for FRTB implementation, including interpretation of the rules and in providing guidelines to banks. Outside of Europe, especially in jurisdictions such as the US, there have been no official statements on rule interpretation from local regulators.

"It is urgent that jurisdictions outside of Europe finalise the interpretation of the [FRTB] rules given the fast-approaching global deadline. Clearly, now is the time when banks have to take actions, specifically if they decide to put some desks on the internal models approach," said Fausto Marseglia, Refinitiv’s Head of Product Management, FRTB and Regulatory Propositions.

The decision on which desks will adopt the internal models approach will have implications on the type of data banks need for passing the risk factor eligibility test (RFET), which is required for desks eligible for the internal models approach (IMA), and how data will be sourced.

Most of the big banks will use their own market risk models for some of their trading desks, and many have begun work, analysing and identifying which desks will adopt the internal models approach versus the standardised approach. Marseglia expects most banks to finalise their decisions between end of 2021 and early 2022.
Risk factors that will be assessed as non-modellable at desk level are critical in determining which desks will adopt the internal models approach. At the desk level, the risk factors that will be considered non-modellable will be excluded by the desk internal models and charged separately with higher capital under the FRTB rules.

Sourcing huge amount of data from different external sources requires banks to put in place the right data management tools and infrastructure as well as data models to ensure consistency.

While the Basel Committee on Banking Supervision has set January 1, 2023 as the global implementation deadline for FRTB, local jurisdictions have the opportunities to tweak the rules and decide the implementation timeline to better reflect local market requirements, Marseglia said. For instance, in Europe the FRTB regulation is implemented under the Capital Requirements Regulation (CRR2) and regulators have split the internal models approach implementation in two phases, with the reporting requirements likely to commence in late 2024, while implementation of capital requirements will likely be live one year later in 2025.

**Risk factor eligibility test**

The risk factor eligibility test, one of the biggest challenges to banks, will require market risk departments to source a huge number of trades and committed quotes to be included in the test. This will require sophisticated, and often cloud-based tools to store, process and analyse very large datasets, according to Marseglia.

The RFET has been introduced to address regulators’ concerns about the quality of input prices that will go into the market risk models for calculating capital requirements.

“Regulators were concerned about the quality of the input prices hitting banks market risk models and wanted to make sure that underlying risk factors were showing sufficient trading activity. The RFET is a liquidity test at risk factor level to check that there is sufficient executed trades or intentions to trade for the underlying financial instruments. Risk factors that will pass the RFET will be considered modellable and could be included in their own risk models, whereas those that aren’t modellable will be excluded and will be subject to a punitive capital charge,” Marseglia said.

Many banks will likely use internal data as their primary source for the liquidity test, but the trading activities carried out at banks are insufficient to consistently pass the RFET, according to Marseglia. For the first time, banks will be forced to source trades and quote data from the external world and they will need to source additional data from vendors that can offer comprehensive cross asset class historical data.

The difficulty and time-consuming process in extracting trades from their oft-silo internal systems, presents a further challenge to banks.

“There’s a lot of work that banks should do. Basically, they are forced to source trades and quotes for assessing the RFET test. The amount of data they have to source is huge since there can be tens of thousands of risk factors for a large bank and this poses challenges,” he said.

**Data challenges**

Sourcing huge amount of data from different external sources requires banks to put in place the right data management tools and infrastructure as well as data models to ensure consistency. The task is especially daunting given that banks typically need to source data from different data vendors for different asset classes.

Further, sourced data needs to be consolidated into a standardised data model to allow aggregation based on instrument attributes and this requires complex rule-mapping to align inconsistent data models across many sources and products, Marseglia said.

But the state of readiness among banks in terms of data infrastructure varies with the larger banks typically more prepared than others.
Uncertainty in FRTB rules

Uncertainty in some aspects of the FRTB rules pose further data challenges. For example, the concept of committed quotes defined by BCBS under the regulation refers to a price at which the provider of the quote must buy or sell a financial instrument, whereas the European Banking Authority takes a more restrictive approach requiring valid committed quotes to have both a bid and an ask leg in order to be eligible for the RFET.

“Our view is that taking the interpretation of a committed quote as providing both a bid and an ask price would be too restrictive and would materially limit the number of quotes eligible for the RFET and this clearly is an additional cause of difficulty for passing the test [risk factor eligibility test],” Marseglia said.

“In many bond and derivative markets, particularly those based on a request for quote trading protocol, firm quotes consist of only a bid or an offer. Also, where such quotes are made public under MiFID II, the obligation for pre-trade transparency does not mandate quotes to have both a bid and an offer,” Marseglia added.

“No other jurisdictions at the moment have published formal documents on how to interpret committed quotes, so this remains an element of uncertainty that can potentially trigger local divergencies of the rules. As a consequence, many customers at the moment have decided not to use quotes for the RFET assessment,” Marseglia said.

Many markets lack transparency

The challenges in passing the eligibility test are further compounded by instruments traded in opaque markets such as over-the-counter (OTC) versus those traded on regulated markets and exchanges. Most of the issues banks face in passing the RFET have to do with illiquid and exotic OTC derivative products as related trade data is generally not made public, according to Marseglia.

The lack of sufficient transparency in many markets from which to identify usable executed trades and committed quotes poses a further challenge.

“While initiatives like MiFID II in Europe can help to provide transparency for OTC products, there is much less transparency for these products in markets outside of Europe, in which case banks have to rely on data coming from their internal trading activity or, more likely, source data from external vendors. There is much work involved in collecting the data,” Marseglia added.


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