A fresh look at the Nordic FRTB implementation effort

September 2020

An update on the Nordic FRTB implementation effort

In this executive summary, we highlight the key insights from our second[1] Nordic survey on the Fundamental Review of the Trading Book (FRTB). The second survey was initiated at the end of 2019. The final FRTB rules were published by the Basel Committee on Banking Supervision (BCBS) in 2019 with the following key objectives:

- A clearly defined boundary between the banking book (BB) and the trading book (TB)
- A revised Internal Models Approach (IMA) that takes into account some of the failings exposed by the 2008 financial crisis and some of the criticisms of the subsequent Basel 2.5 revisions (e.g. by accounting for illiquidity and by placing restrictions on banks' use of data and ability to diversify risk factors without sufficient historical justification)
- A more credible Standardised Approach (SA) that serves as a fall-back for Internal Models and less supervisory discretion (i.e. automated tests) to determine what is eligible for SA vs IMA.

The purpose of the annual Nordic survey is to provide participants with insight into overall industry progress and the pain points experienced by others during the lead-up to the final implementation date.

[1] See this source
[2] See this source
[3] See this source
[4] See this source
[5] See this source

Regulatory update
In March 2020, the European Banking Authority (EBA) published[2] its final draft Regulatory Technical Standards (RTSs) on the new Internal Model Approach (IMA) under the FRTB. These technical standards conclude the first phase of the EBA roadmap towards the implementation of the market and counterparty credit risk frameworks in the EU.
The adoption of those RTSs is expected, under the current Capital Requirements Regulation (CRR2), to trigger the three-year period after which institutions with permission to use the FRTB internal models are required, for reporting purposes only, to calculate their own funds requirements for market risk with those internal models.

As part of the regulatory response to COVID-19, regulators have announced a number of delays to consultations and rule finalisation in order to re-focus their efforts or ease the operational burden on firms at this time. This was initiated by the BCBS[3] who delayed the implementation of the Basel III framework by one year to 1 January 2023. This delay includes all the Basel III components agreed in December 2017, including the full implementation of the FRTB. In April 2020, the EBA published a statement[4] on the application of the prudential framework on targeted aspects in the area of market risk in the COVID-19 outbreak. In this announcement the EBA deferred the implementation date of the revised market risk framework by one year to 1 January 2023.

More recently in May 2020, the EBA published[5] its final draft Implementing Technical Standards (ITSs) on specific reporting requirements for market risk. These ITSs introduce the first elements of the FRTB into the EU prudential framework by means of a reporting requirement. The result is that the FRTB-SA reporting requirement in the EU will be postponed from Q1 2020 to Q3 2021 (the first reference date is set at 30 September 2021), if the draft ITSs are endorsed by the Commission. This extension should allow institutions to focus on their core operations and should provide some operational relief, whilst not undermining the smooth implementation of the FRTB in the EU.

Survey results

In this report, we highlight some key insights from the Nordic survey.

The survey addressed all major areas of FRTB and was grouped into ten sections with approximately 50 questions, covering the themes listed below:

01. General

02. Standardised Approach

03. Internal Models Approach

04. Stress Testing and Economic Capital

05. Model Performance

06. Non-Modellable Risk Factors (NMRFs)

07. Overall Capital Impact

08. Regulatory Boundary and Internal Risk Transfers (IRTs)

09. Business Strategy

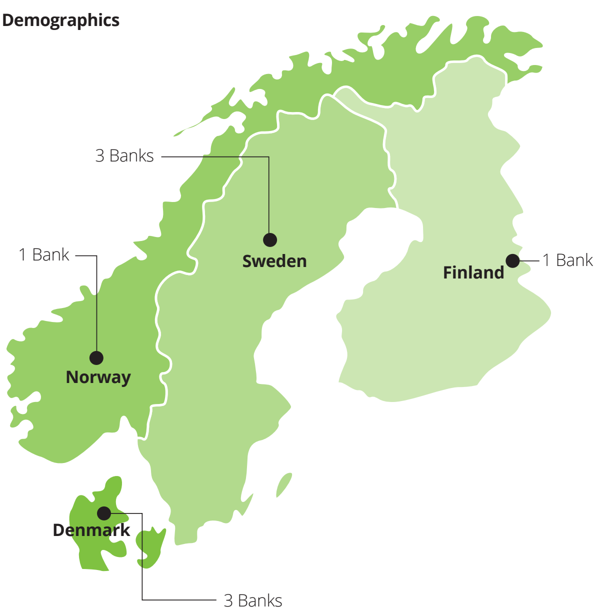
10. CVA Capital Charge[6]

[6] The CVA capital charge calculation is technically not part of the FRTB regulation, but forms part of the broader Basel III framework. As the risk management of counterparty credit risk typically aligns closely to the market risk management team, we included this topic.

The survey participants are spread across the Nordic region, with the most participants' head offices located in Denmark and Sweden.

The majority of participants have total assets of more than €200bn.

Demographics

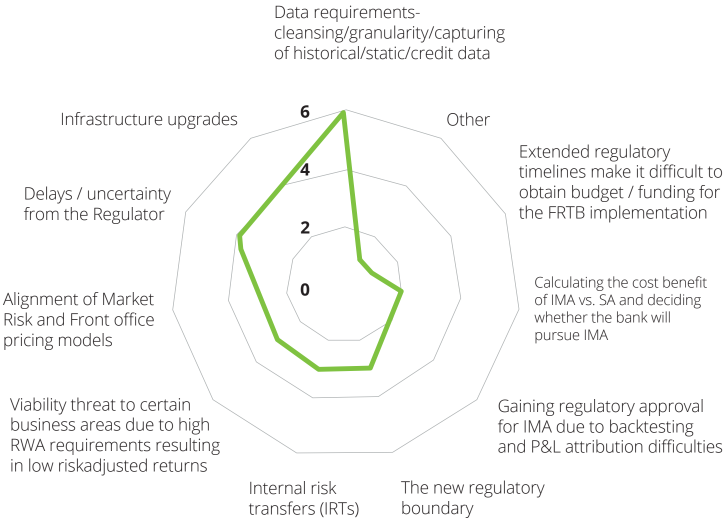


The common challenge facing participating banks with regards to the implementation of FRTB has moved from regulatory uncertainty in the 2018 survey to data requirements in the 2019 survey.

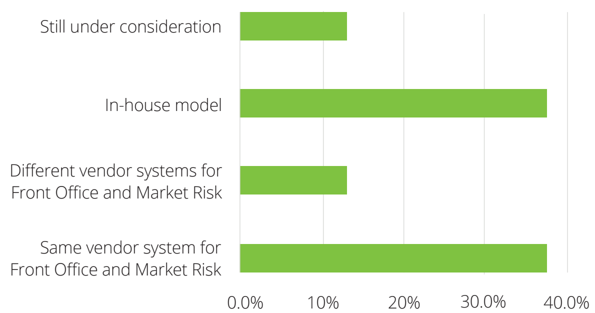
This relates specifically to the cleansing, level of granularity and the capture of historical data, static data and credit data. Calculating the cost benefit of SA vs IMA and difficulty to obtain funding due to extended timelines are seen as the least challenging areas.

In relation to banks' strategic system solution for FRTB, most participants plan to either use an in-house model, or the same vendor system for Front Office (FO) and Market Risk which is largely consistent with the prior year responses.

What do you consider to be the main challenges that you will face to deliver FRTB?



What will your strategic system solution for FRTB be?



Most participating banks are still in the early stages of their SA implementation and testing.

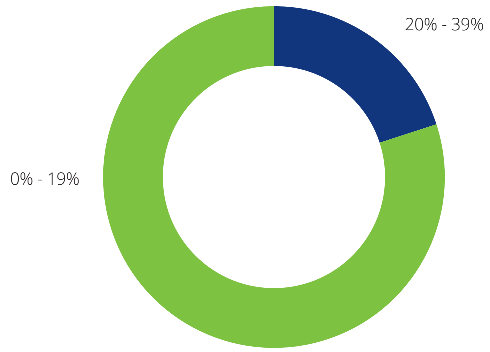
There has been some progress on the strategic SA implementation, but still only 25% of participants have progressed above 39% with their strategic implementation.

This also means that the majority of participants have not yet done any investigations on optimisation of the capital charge within the rules but would like to identify opportunities to do so.

Banks previously on "hiatus" due to regulatory uncertainty will have to ramp up their FRTB efforts to ensure they can meet the EU reporting requirements in Q3 2021.

The most common implementation challenge for the SA implementation remains the sourcing/preparation of clean and consistent static data for bucketing purposes.

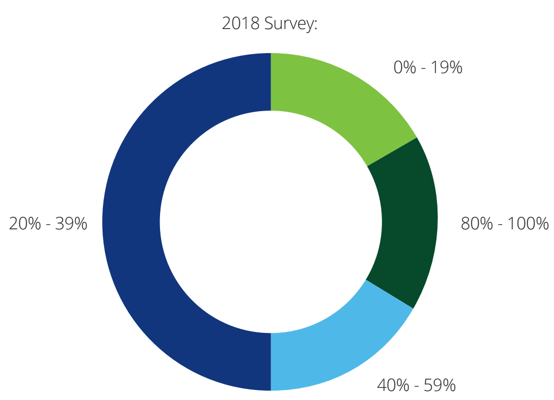
What is the estimated completion of your strategic IMA implementation?

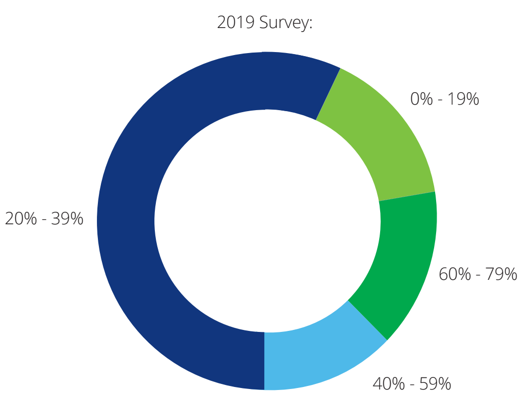


Most participants have initiated their IMA programmes with only a few participants progressing above 20%. This is consistent with the 2018 results indicating that banks' efforts were focussed on their strategic SA implementation over the last year.

Only 5 out of the 8 participating banks are considering to implement the IMA.

What is the estimated completion of your strategic SA implementation?





Under the final FRTB rules, most participants believe that some of their risk factors (RFs) are non-modellable, with an equal number of participants estimating that more than 40% of their current population of RFs are non-modellable.

This is similar to the estimates from the prior year's survey and shows that it is clearly an area of uncertainty that will become more clear as strategic decisions are made about pursuing IMA.

At this stage, it is unclear whether the modellability requirement of RFs under FRTB would have a significant part to play in banks' decision-making around new desk structures.

The high cost of data vendor solutions for modellability flags / input is a concern.

At the time of the survey, most participants had not made much progress in defining and documenting risk factors, their bucketing and the data source lineage under FRTB.

This is likely to change as banks work through the EBA's RTSs[7] on the criteria for assessing the modellability of risk factors under the IMA and participate in the consultation launched by the EBA[8] on the technical standards on capital requirements of non-modellable risks under the FRTB.

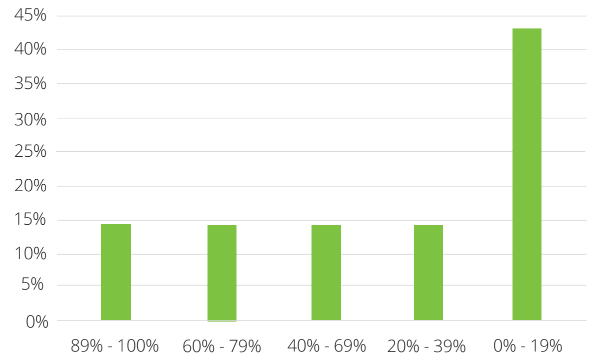
While it is difficult to estimate the overall impact, this process could be crucial for many banks in order to understand whether there is indeed a capital benefit to using IMA compared to SA.

Although there are a number of challenges with regard to the Regulatory Boundary & IRTs, the most challenging items to implement are documenting IRT strategies and the process for obtaining supervisory approval of transfers.

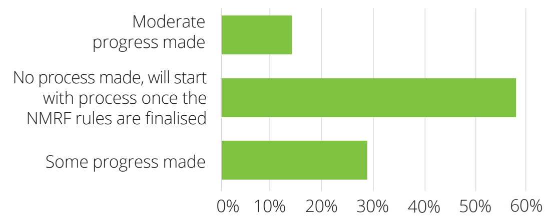
From the survey, it is understood that participating banks seem to prefer hedging banking book risk with a designated IRT desk under the new FRTB rules.

[7] See this source.
[8] See this source.

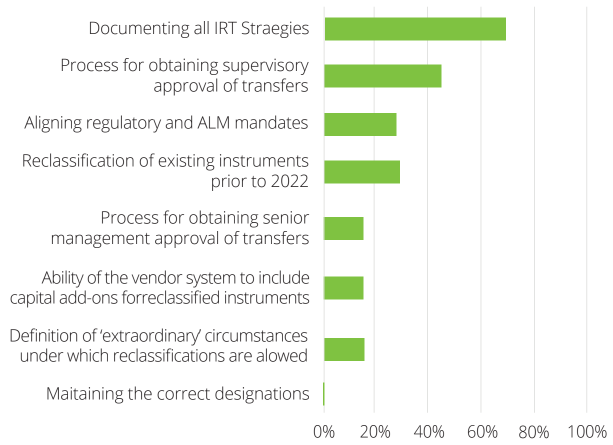
What percentage of your current population of risk factors estimate are non-modellable under the current FRTB rules?



How much progress have you made in defining and documenting risk factors, their bucketing, and data source lineage under FRTB?



Which of the following items, in relation to the Regulatory Boundary and Internal Risk Transfers, would be the most challenging to implement?



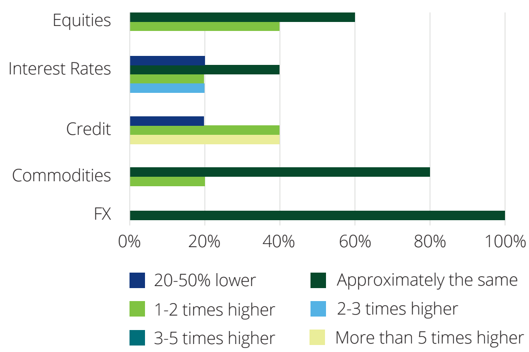
Some of the questions related to the capital impact had a low response rate indicating a low level of maturity, and a high level of uncertainty around the overall capital impact which is consistent with the prior year's survey results.

The capital from FX risk and Commodity risk is expected to be approximately the same under FRTB, whereas credit risk is expected to be significantly higher.

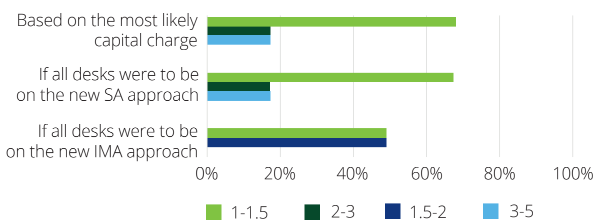
Most participating banks expect their capital charge to increase by between 1 and 1.5 times, if all desks were to be on the new SA approach, which is much lower than the ratio estimated in the 2018 survey where it was between 1.5 and 3 times.

The most common contributing factor for the increase in a bank's overall capital charge is the Default Risk Charge (DRC) for credit and equity, followed by delta and vega charges for desks on SA. Some banks indicated that NMRFs will lead to a significant increase in capital.

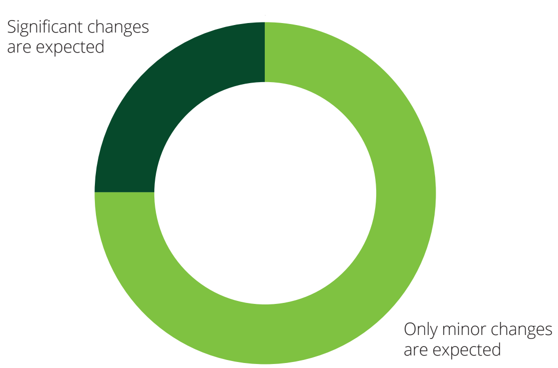
To what extent do you foresee the capital allocations would change between different trading desks? (I.e. in which asset class do you see the biggest increases / decreases in capital allocations)



Compared to your current capital charge (assuming a multiplier of 3 for current IMA, and including both general and specific risk), what is the increase (>1) or decrease (<1) in capital charge:



Do you expect changes to your current desk structure (other than those driven by IRT rules and the new regulatory boundary) under FRTB?



There are varying views on the future business strategy of banks, and the products that they will offer their clients. In general, the majority of banks expect minor changes to their desk structures.

The top 3 considerations as deemed by participating banks in amending their desk structures are:

- Recognition of internal hedges in the capital calculation
- Obtaining maximum IMA coverage
- Optimising capital allocation.

Key takeaways from the Nordic survey:

The responses in some of the sections of the survey indicate that some areas of FRTB are better understood than others.

The increased certainty and direction provided by the EBA (in the form of the ITSs and RTSs) on various aspects of the FRTB will likely accelerate banks' implementation efforts over the remainder of 2020 and into 2021.

Banks are likely to focus their resources on the implementation of the SA, which could lead to added pressure on teams to meet IMA requirements by 1 January 2023.

Based on the results of this year's survey, we recommend that Nordic banks pay specific attention to:

- Estimating the capital impact under different assumptions to facilitate strategic decision-making such as programme design, prioritisation and sequencing. This process could also lead to identifying optimisation opportunities.

- Ensuring that their FRTB programmes are on track to meet all the reporting requirements under the SA by Q3 2021. Consideration should be given to the fact that the final implementation of the SA will most likely result in the reengineering of many processes closer to the reporting date, and perhaps even new or updated operating models.

- Allocating sufficient dedicated resources to their IMA implementation programmes to maintain momentum on progress made to date. The timelines and effort required for FRTB implementation mean that it is essential to work on prototypes for capital impact assessment and the strategic solution in parallel.

- Considering the different NMRF solutions available to avoid a high percentage of NMRFs and thus increased capital.

How we can support:

The BCBS's FRTB guidance touches many areas of internationally active banks. Implementation of the guidance requires not only an understanding of the immediate impacts, but also insight into potential long-range challenges, including capital impact, optimisation and business strategy, P&L attribution and NMRFs, IT implementation and target operating models. To address these challenges, banks have looked to Deloitte's FRTB front-to-back advisory services over the past five years for a refreshing approach to FRTB implementation. Key features of our approach include:

- **Front-office advisory:** An in-depth capital impact assessment focused on generating strategic insights and understanding. Leveraging Deloitte's proprietary attribution methodology, we can help transform quantitative impact study (QIS) data into usable information, review and prioritise the build, and provide strategic input into effective desk structure, capital mitigation and hedging strategies, and benchmarking assumptions against peers. We can also assist with trading book boundary implementation, booking models for internal risk transfers, and design of control and monitoring frameworks.

- **Methodology support and design solutioning:** Highly experienced and specialised support for risk methodology and front-office quant functions, prototyping models, and tactical solutions. We can provide regulatory interpretation, peer benchmarking and front-to-back IT infrastructure solutioning, as well as advising on the building out of NRMF frameworks and assisting with profit-and-loss attribution (PLA) remediation.

- **Programme support and defining the target operating model:** Review of existing target operating model, FRTB process benchmarking and review of business requirements against the bank's strategic objectives. We can develop recommendations for an end-to-end target operating model that is FRTB compliant and focused on alleviating pain points for the business, including project management structuring and support, strategic planning, and gap assessments.

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