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2. Overview of Development in Financial Regulations (Trends & Topics)

 # Review of the Fundamental Review (Shiro Katsufuji, Director, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

The last pending item in the Basel III reform, the minimum capital requirements for market risk (so-called Fundamental review of the trading book, or FRTB), made progress toward resolution. On March 22, the Basel Committee of Banking Supervision (BCBS) published a consultative document on “Revisions to the minimum capital requirements for market risk.” It presents amendments to the requirements in the 2016 final document, reflecting certain challenges private financial institutions had identified. Specifically, changes have been proposed to a profit and loss attribution (PLA) test regarding usage of the internal model approach (IMA) to calculate risk-weighted assets (RWA) as well as the rules for non-modellable factors (NMRF). In Basel regulation, it is exceptional to drastically revise rules during the period between the release of a final document and its implementation.

In the 2016 standard, restriction of the use of IMA in market risk measurement was tighter than expected, which would force adoption of the standardized approach (SA) in many cases. The PLA test was established to best align recognition of profit and loss (P&L) in the front office and risk measurement. The method and threshold to evaluate the consistency between these two were overly rigid and simplified in the 2016 document. Hence, the latest revision proposes to apply a statistical method to determine the P&L analysis standards, enabling a framework for more reasonable implementation of the analysis. As for NMRF, more accurate risk measurement is pursued by utilizing “real prices” as a sole risk factor (i.e. valuation rates) for risk evaluation. The 2016 document’s definition of these real prices was extremely limited; the definition judged many of the risk factors as non-modellable and often required additional capital. The latest amendment relaxes part of this requirement, and calls for public consultation on further revisions.

Ideally, risk management should be based on highly risk-sensitive internal models. The challenges with the 2016 standard was its severe restriction on the internal model approach (IMA). The latest amendment properly reflects the public's voice to better balance the limits imposed on the use of internal models. It is noteworthy that the proposal realizes a more empirical approach to assess suitability of the IMA by adopting a statistical method in the PLA test. On the other hand, there is no fundamental revision on the definition of risk factors from the 2016 document, and the BCBS will continue requesting further comments from the public. The validity of the current proposal will be examined by testing RWA calculations and risk factor certification based on the draft. The NMRF rule, in particular, will demand more in-depth revision to develop realistic regulatory requirements.

Due to its intricate nature, the FRTB regime has become more complex than its initial draft. The pursuit of ideal, such as consistency in actual P&L and that in risk theories, or usage of valuation rates observed in real markets, led to excessively strict requirements. Unnecessarily complex regulation would not only impose additional cost for compliance and delay implementation, but also cause excessive rise in capital requirements, serving against the essential objectives of risk management. Discussion around the revision of the FRTB is a meaningful process to bring financial regulation back to its original purpose. Adequate discussion between public and private stakeholders is necessary, including on the NMRF. The FRTB regime is scheduled for implementation from the beginning of 2022. For private banking institutions to have sufficient time to prepare, the regulation has to be finalized within 2018. Although the clock is ticking, it would be best to consider various options from both supervisory and business perspectives, and finalize the rules with mutual agreement between public and private sectors since this internal regulation will be applicable for a long period of time.
