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Global Risk Watch Newsletter

Worsening Allergies to "Uncertainty" in the Global Financial Markets, etc.

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

 # What are the Consequences of Regulatory Reforms on the Market Risk? (Koichi Iwai, Senior Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

In the midst of agitating financial markets worldwide, perhaps it is coincidental, but regulatory reforms, which would have effects on the trading business and market liquidity, have shown significant development. The Basel Committee on Banking Supervision (BCBS) issued final rule on 'Minimum capital requirements for Market Risk' on January 14th. This is the final outcome of the so-called 'FRTB: Fundamental Review of the Trading Book'. Its main points can be summarized in the following five points.

1. A revised internal models approach for market risk; The new approach introduces a more rigorous model approval process. It also sets constraints on the capital-reducing effects of hedging and diversification.

2. A revised standardised approach for market risk; The standardised approach is overhauled to make it sufficiently risk-sensitive to serve as a credible fallback as well as a floor to the internal models approach.

3. A shift from value-at-risk to an expected shortfall measure of risk under stress; Use of expected shortfall will help to ensure prudent capture of "tail risk" and maintain capital adequacy during periods of significant market stress.

4. Incorporation of the risk of market illiquidity; Varying liquidity horizons are incorporated into the revised standardised and internal model approaches to mitigate the risk of a sudden and severe impairment of market liquidity across asset markets.

5. A revised boundary between the trading book and banking book; A better defined boundary will serve to reduce incentives to arbitrage between the regulatory banking and trading books, while still respecting banks' risk management practices.

This final rule is calibrated to strengthen and enhance market risk management in the financial institutions, while intended to rationalize the capital charges against market risks. Although the degree of impact on the capital charges for each bank will depend on the contents of the trading businesses, thus cannot categorize all in one. However, it can be said that more banks are required to increase holding capitals as compared to the existing regime. The revised market risk framework will come into effect in 2019. Since the final rule is revealed, how financial institutions will take correspondence measures must be carefully observed. In the past few years, major financial institutions in the US and Europe have already begun to reduce trading business mainly in the market making business area. Therefore, should this trend seem to continue further in the wake of the finalized FRTB, market liquidity is likely to face further downward pressures.

How are the approaches of supervisory authorities to balance the dilemma of necessity of regulatory reforms and decline of market liquidity? At this point, decline in market liquidity due to increased regulations is considered a necessary evil, as it seems to be the majority consensus. One particular example is the ‘Fixed income market liquidity’ report released by Bank for International Settlements (BIS), Committee on the Global Financial System (CGFS), on January 21st. This committee is chaired by William C Dudley, President of the Federal Reserve Bank of New York. This report pointed out that “Dealers have continued to cut back their market-making capacity in many jurisdictions.” and “More stringent regulatory requirements had effects to curb dealers’ risk-taking capacity. As a result, many dealers reportedly provide liquidity only when they can easily match client orders, but step back from quoting during more volatile market conditions”. However, this report does not suggest that relaxation of regulations is necessary, as Chairman Dudley concluded that “Fixed income markets are in a state of transition. Yet, in the mid-long term, measures to bolster market intermediaries’ risk-absorption capacity will strengthen systemic stability”.

Considering what has been addressed in the above, as financial institutions will be forced to revise business models due to tightening of regulations, this will trigger market liquidity decline, and ultimately increase ‘demand’ for the central bank to inject more liquidity supply. Moreover, in case the central bank cannot supply the sufficient liquidity, liquidity shock may also spread to the global market. When the shocks in the market continue, financial institutions might face a vicious cycle in that they are forced to reduce further their trading business. In any case, this finalized

FRTB is a significant progress on the regulatory reforms, and the possible effects of this reform on strategies of financial institutions and the financial market must be carefully observed.