An impractical white elephant

The Basel Committee's Fundamental review of the trading book raises some serious issues but David Rowe argues its central proposed revision to the market risk capital regime is little more than a costly distraction

There are some good things in the *Fundamental review of the trading book* – the Basel Committee on Banking Supervision's plans for an overhaul of the market risk capital regime.[1] Unfortunately, the document also contains at least one horribly impractical white elephant.

On the plus side, the review highlights the inadequacy of estimates of short-term volatility rooted exclusively in a rolling sample of the latest market data. It has been long recognised that such estimates create pro-cyclical capital requirements. They can also lull institutions into a false sense of security during extended periods of low volatility such as in 2004–06.

For both these reasons, the review's emphasis on the concept of stressed value-at-risk (sVAR) is welcome – as is its proposal to use a single sVAR measure as the basis for the capital charge. This replaces the awkward combination of VAR and sVAR that raised irresolvable issues of double counting.

Regulators also sensibly propose a desk-by-desk approval process for internal models. This "provides regulators with the ability to revoke models for specific trading activities without forcing banks to apply the… standardised approach to the entire trading book".[2]

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I concur with the regulatory consensus that trading book assets were under-assessed in the Basel II framework relative to banking book assets, leading to a strong incentive to shift assets into the trading book wherever possible. A separate Basel Committee project – its Regulatory Consistency Assessment Program (RCAP) – appears to offer preliminary evidence that this incentive has been tackled through the post-crisis trading book reforms often referred to as Basel 2.5.[3]

Unfortunately, the trading book review refuses to let well enough alone. One inappropriate innovation, the shortcomings of which I have discussed previously, is replacing VAR with expected shortfall – the expected value of all losses greater than a specific threshold (*Risk* December 2012, page 68, *www.risk.net/2216891*). Besides adding little useful information in practice, expected shortfall is impossible to back-test, since actual realised values are never observed.

More seriously, the review belabours the issue of observable inconsistencies in modelled market risk capital charges. The earlier RCAP report is careful to point out that: "A sizeable portion of the variation is due to supervisory decisions applied either to all banks in a jurisdiction, or to individual banks." Even when it says: "Another important source of variation is due to modelling choices made by banks," it immediately adds that: "The exercise found that a small number of key modelling choices are the main drivers of the remaining model-driven variability."[4] Two modelling choices in particular are cited in this regard: different historical lookback periods, and different methods for accommodating the 10-day horizon on which the capital charge must be based.

If greater consistency is to be a regulatory goal, narrowing the range of choices allowed in these two areas would go a long way towards achieving it.

Sometimes, the review appears bent on playing to the popular view that banks' internal models are unreliable and subject to rampant manipulation. This view is not supported by facts or experience. Nevertheless, rather than simply narrowing the range of technical choices for internal models, one proposal envisages an elaborate revision to the existing standardised approach.

This takes me back to regulators' original 1993 proposal for a market risk capital charge. At that time, I wrote something like two-thirds of the Bank of America response. The essence of this and other industry responses was that the proposal was at least two generations behind what banks were already doing as part of their own internal risk management.

Developing the infrastructure to support the proposed approach would have been a purely compliance exercise with no contribution to actual risk management decisions – and despite past and proposed revisions, the standardised approach remains a shaky second-best framework for estimating market risk. It is an even less reliable structure for conducting stress tests and scenario analysis, since it homogenises away the details of trades with significant non-linear behaviour.

Most disturbingly, it is now proposed that the revised, and now highly complex, standardised approach must be implemented by all banks, including those with approved internal models. It appears those behind the proposal have little or no appreciation of how complex, costly and error-prone such an effort would be. Hopefully, when naive theory collides with practical reality, the Basel Committee will put this idea where it belongs – on the regulatory scrapheap. **R**

[1] *See Basel Committee on Banking Supervision, Fundamental review of the trading book: a revised market risk framework, October 2013*
[2] *Ibid, page 25*
[3] *See Basel Committee on Banking Supervision, Regulatory consistency assessment programme (RCAP) – analysis of risk-weighted assets for market risk, January 2013 (revised February 2013), especially pages 20–22*
[4] *Op cit, page 7*