Regulatory landscape for banks: latest developments on the use of internal models

Basel Committee report on the consistency of risk-weighted assets for market risk

The Basel Committee has published a report\(^1\) on its review of risk-weighted asset (RWAs) for market risk, highlighting substantial differences in the RWAs of trading portfolios across banks. Most importantly, the report provides indications of the future direction of regulation in the area of internal models and the regulatory risk weighting regime more broadly. It will have a strong impact on the outcome of the Committee’s ongoing fundamental review of the trading book. In parallel, the Committee is undertaking a review of the variability in outcomes from the internal ratings based (IRB) approach for credit risk. Both RWA reviews form part of the Basel Committee Regulatory Consistency Programme, a key part of which is to assess the consistency of banks’ risk weighted asset outcomes.

The business implications of the market and credit risk RWA reviews will be profound. Banks can expect additional constraints on internal modeling choices, supervisory approval processes will become stricter and disclosure requirements will be increased. Banks will need to ensure that they develop a cost effective strategy to integrate these expected changes to the risk weighting framework into their in-flight regulatory capital reform programs.

Key findings

The report highlights three sources of difference for the market risk RWAs – genuine differences in business models, supervisory decisions in different jurisdictions and modeling choices made by the banks. Analysis of publicly available data showed that the average risk weighting of trading assets varied from around 15% to 45% for most banks, which the Committee acknowledges would be justifiable if it reflected the portfolio composition – for example, a greater volume of illiquid assets driving up the RWAs for some banks. To explore underlying causes and assess whether differences in the portfolios was the driver, the Committee carried out a hypothetical test portfolio exercise covering 15 banks with sizeable trading portfolios spanning the US, Europe and the Far East.

- 27% of the difference was due to choices made by the supervisors, in particular the size of the regulatory multiplier being applied to the Value-at-Risk (VaR) and stressed VaR (sVaR) outcomes. Supervisors have applied a range of multipliers from 3 to 5.5.
- Modeling choices allowed under the rules also create substantial variation, with the newer, more complex models resulting in the greatest variations across banks.

In addition, the Committee found significant variation in the way that the market risk outcomes were disclosed, and that it was not possible to explain the drivers of RWA variation based on banks’ public disclosures.

\(^1\) Basel Committee on Banking Supervision, *Regulatory consistency assessment programme (RCAP) – Analysis of risk-weighted assets for market risk* (January 2013).
Policy implications

The paper sets out the Committee’s thinking on possible policy options to deal with the variation, which will have implications for the direction of Committee’s ongoing fundamental review of the trading book.

- **Improvement in public disclosure and regulatory data collection to aid understanding of RWAs.** This could include banks providing more granular information regarding the components of market risk RWAs and VaR and other market risk models. The Committee is considering common standards on frequency of disclosure, explanations of RWA drivers, more granular segmentation of the components of RWAs and enhanced disclosure of key modeling choices.

- **Narrowing modeling choices for banks.** This will be considered as part of the fundamental trading book review and may include closely defining the modeling approach for the credit models and reducing flexibility in choosing the length of historic data for the VaR.

- **Further harmonization of supervisory approaches with regard to models approvals.** This could include developing supervisory guidance to uphold a consistent approach to model standards and approval of use of models. One possibility is the creation of an international team to monitor international standards.

There will also be a further exercise to look at more complex products and credit risk mitigation.

In terms of the IRB approach for credit risk, which comes under a separate exercise, one area being considered is greater use of floors for probabilities of default and possibly for loss, given default for portfolios where there are a small number of defaults. But this report on market risk indicates that the Committee may pursue some reduction in modeling choices, greater disclosure and more standardization of supervisory approach.

Encouragingly, the Committee points out that the Basel standards deliberately allow banks and supervisors some flexibility in measuring risks. In addition the Committee recognizes that some diversity in risk management practice is desirable to avoid ‘group think’ and to promote the “use test” as a way to enhance confidence in banks’ regulatory capital models. But nonetheless, the Committee will take steps to avoid excessive variation in measurement of RWAs.

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FSO global regulatory network

Ernst & Young's Global Regulatory Network is an integral part of our Financial Services Office and enables EY to offer banks deep experience, leadership and insights on financial regulation.

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Stefan Walter is the former Secretary General of the Basel Committee on Banking Supervision from 2006 to 2011. During this time he also was a member of the Financial Stability Board. He has more than 20 years of international bank supervisory experience including 15 years at the Federal Reserve Bank of New York.

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