



Finance Watch

Making finance serve society

Curbing subjectivity: A technical brief on the Fundamental Review of the Trading Book proposal

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A Finance Watch Policy Brief

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Executive summary:

This note provides Finance Watch's assessment of the proposals of the Basel Committee on Banking Supervision figuring in the "Fundamental Review of the Trading Book"¹. This set of proposals aims at reinforcing banks' robustness by strengthening the distinction between banking and trading book, where banks book their financial assets. The trading book includes all positions that banks intend to trade actively and is focused on market risk, while the banking book includes all positions that banks intend to hold until maturity and is focused on default risk. The differential prudential treatment was originally meant to reflect the presumed liquidity advantages of actively traded assets through lower capital requirements and use of internal models for risk assessment but in practice led to regulatory arbitrage, since the distinction between books was solely based on intention and easily circumvented.

After some short-term fixes, such as add-ons to regulatory capital charges, the Basel Committee decided to further fix its regulatory framework. The main changes include a new definition of the boundary between banking and trading books, the use of the Expected Shortfall instead of the Value-at-Risk as a risk metric, and changes in the Standardised approach.

Finance Watch welcomes the Basel Committee's proposal to revise the market risk framework for the trading book, which has proven to be ineffective during the past crisis. We have however some reservations on some of the recommendations:

1. In our view, a truly objective boundary between books should be made through the use of accounting standards in order to remove any intent in the definition.
2. Moreover, although the Expected Shortfall is a superior risk metric compared to the Value-at-Risk, the overreliance on a single mathematical figure to assess risks is dangerous.
3. Lastly, the use of a less risk-sensitive Standardised approach, along with aggregate risk-neutral metrics, should be sufficient to provide an effective, balanced and transparent micro-prudential framework.

Introduction:

The Fundamental Review of the Trading Book is part of a broader effort from the Basel Committee on Banking Supervision² to improve the robustness and reliability of banks' prudential framework in the wake of the financial crisis.

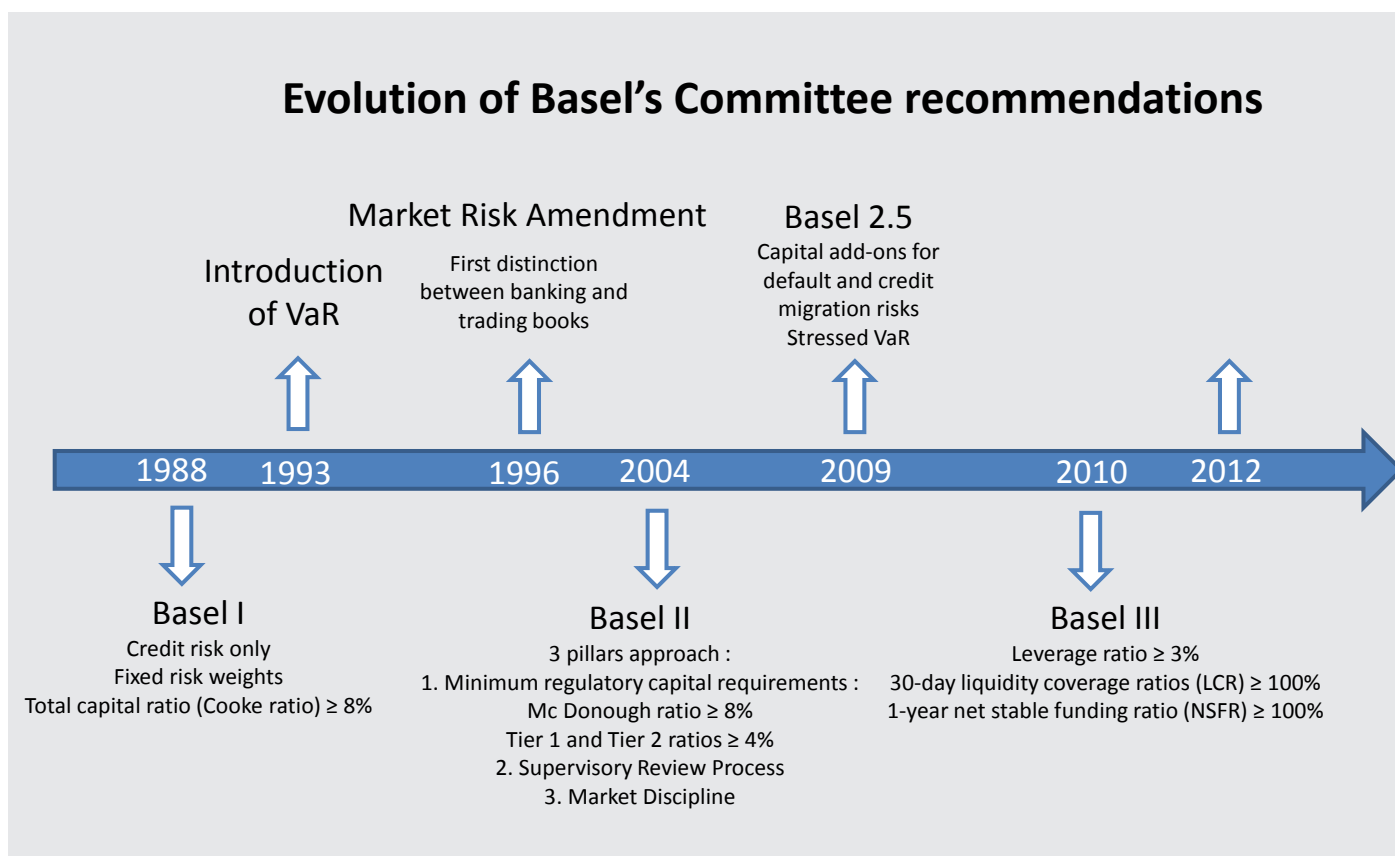
The crisis provided evidence of significant regulatory arbitrage as many firms used loopholes in the regulatory framework in place in order to circumvent rules. This led to inadequate capitalization and loss absorbency capacity and also demonstrated the lack of predictive power of regulatory capital on banks' distance to default.

The first Basel Accord in 1988 aimed at setting international capital adequacy standards for banks' exposures to credit risk: the idea was to make banks finance their activities with enough of their own capital to be able to absorb potential losses. These recommendations are now referred to as Pillar 1, and were complemented in 1996 by a market risk amendment that

accounted for the exposure to market-related risk through the trading of financial assets and derivatives. At that time, a distinction was first made between the banking book and the trading book in order to reflect the presumed liquidity advantages of trading assets over buy-and-hold positions (kept in the banking book) through lower capital requirements, along with authorizing the use of internal model to assess risk weights of market risk exposures.

This differential treatment opened the door to regulatory arbitrage, as the distinction was only based on intent and gave banks significant leeway to shift exposures between books.

This phenomenon amplified as markets for derivatives exploded. This is why new measures based on additional regulatory capital charges were included in the Basel II Accord (2004) along with some short-term fixes (Basel 2.5) following the subprime crisis in 2009.



None of those measures have been strong enough, however, to prevent banks from shifting their exposures to the book in which capital requirements were the lowest.

This ability to arbitrage the boundary between the banking book and the trading book in order to benefit from a more favourable prudential treatment made it necessary to revise the regulation of market risk. This is why BCBS proposed a new approach in 2012, intended to be more comprehensive, and including a new definition of the trading book, the use of a new risk metric, the Expected Shortfall³, and revisions of both the internal model-based and the standardised approach for risk weights calculations.

The Basel Accords have always put more focus on default risk than market risk, but the financial crisis has shown that market risks, especially credit and liquidity risks, are very frequent and can lead to huge losses as well. In the late '80s, the limited size of trading books and lower amount of derivatives traded

may have explained the lack of regulatory intervention. Today however, and for two decades now, the situation has completely changed, while very little has been done at the regulatory level. Banks have become more and more vulnerable to market movements, making it all the more urgent to address these issues.

Despite the change in political momentum that recently shifted away from financial stability concerns, we strongly hope that these recommendations will be translated in the near future into Level 1 regulatory proposals given the high importance of the matters at stake.

We cannot emphasize enough the fact that financial stability is a pre-requisite to sustainable growth, not an impediment. Going back to a short-sighted focus on growth and competitiveness would be detrimental given the huge and lasting cost of financial crises on the real economy.

CONTENT

Executive summary.....	2
Introduction.....	3
I. Trading book boundary.....	5
a. What is the distinction?	
b. What is BCBS proposing to do and why?	
c. Finance Watch's view	
II. Expected shortfall: a superior risk metric, though still illusory.....	8
a. Definitions of VaR and Expected Shortfall	
b. What is the rationale for the change?	
c. Finance Watch's view	
III. New standardised approach: a failed balance between risk sensitivity, simplicity and comparability.....	10
a. The current standardised approach	
b. The proposed future standardised approach and the rationale for it	
c. Finance Watch's view	
IV. Illiquidity, diversification and endogenous risks.....	12
a. Proposed change and rationale	
b. Finance Watch's view	
Conclusion and recommendations.....	14

I. Trading book boundary

Trading Book

- Only intended actively traded positions
- Focus on market risk
- Held at fair value
- Capital requirements based on a 10-day liquidity horizon

Banking Book

- Only intended buy-and-hold positions
- Focus on default risk
- Held at historical value
- Capital requirements based on a one year holding period

A. WHAT IS THE DISTINCTION?

Currently, banks can choose to allocate the financial instruments they invest in between two different books depending on the intention behind their acquisition: if they intend to trade those instruments actively in the foreseeable future they have to book them in their trading book, whereas if they intend to buy those instruments to hold them until maturity, they have to book them in their banking book. Thus, the trading book refers to positions that are more subject to market risk than to credit risk, since the bank does not plan on holding them until maturity but rather actively managing them, so they can sell them before experiencing any default.

Trading book instruments are held at fair value, and are therefore subject to market price changes. In contrast, banking book instruments are priced at historical value, which means that they are considered less sensitive to market price volatility.

Since the holding intent of these financial instruments differs, regulators have defined different capital requirements depending on the book they belong to. Capital requirements for trading book positions are calculated with a 10-day liquidity horizon, reflecting the assumption that ten days would be enough to sell them on the market, while capital requirements

for banking book instruments are calculated within a one year holding period, reflecting their average holding period to maturity.

B. WHAT IS BCBS PROPOSING TO DO AND WHY?

The current definition clearly lacks objectivity, since the only criterion for booking a position is based on the intent of the bank, i.e. whether or not the bank intends to trade actively the asset in its book, which renders regulatory capital arbitrage all the easier: banks can choose the option that minimizes regulatory capital for a given asset by claiming the corresponding intent. As an example during the subprime crisis, many credit derivatives, such as collateralized debt obligations (CDOs), were booked in the trading book, and therefore subjected to capital requirement only regarding market risk and not credit risk. When market prices for these instruments collapsed, they became illiquid: banks were unable to get rid of them but they had not set aside enough capital to write them down and recognise the losses. This is why BCBS plans to revise the definition of the trading book by changing it into a more objective one.

Initially, BCBS proposed two alternatives: completely change the rationale behind the current definition by using international accounting standards, or keep the current spirit of the definition but make some changes to curb subjectivity. An accounting definition based on the fair-value of financial instruments on banks' balance sheets would have been the most objective choice, because **it would remove the discretionary judgment and ensure that every bank allocates their instruments in a consistent way.**

However, BCBS has pushed instead for a revised intent-based definition in which they set new standards⁴ for assigning instruments to the trading book, but if banks desire to do otherwise, they are allowed to do so provided they manage to prove (through documentation) to their supervisor the legitimacy of their request.

Switches between books will also be strictly limited, and allowed only under exceptional circumstances. Additionally, switches can no longer provide regulatory gain: if the capital requirement gets lower after a switch, then banks are required to keep a capital add-on equal to the difference between the previous and the new capital requirement.

Lastly, BCBS also aims to remove incentives for capital arbitrage by realigning capital requirements between the banking book and the trading book. In particular, they intend to change the liquidity horizon of the trading book by adopting a more granular approach. Rather than assuming a ten-day horizon for any instrument in the trading book, as is currently the case, there will be different holding periods varying from ten days to one year depending on the market risk involved (credit, equity, interest rate, commodity or foreign exchange).

C. FINANCE WATCH'S VIEW

First, the boundary between the banking book and the trading book seems artificial and of dubious use, as any financial instrument figuring on a bank's balance sheet should be assumed to be exposed to market risk, whatever the intent or accounting treatment. Giving a differential treatment to a position based on pure intent not only can lead easily to arbitrage (as we saw before the crisis), but also assumes that the intention put behind an investment mitigates the market risks being taken. Ultimately, it would only make sense if one could execute a trading strategy independently of market conditions, which is unrealistic. Of course, the intention behind an investment is relevant from a risk and reward perspective, and can have an impact on strategies, but it should not be considered as a determinant for regulatory and prudential treatment.

More generally, if a boundary needs to be drawn at all, we believe that a valuation-based distinction, based on accounting standards (IFRS 9), would be more appropriate since it reflects more objectively the reality of financial instruments: as long as they are held at fair-value, their price is subject to market change, regardless of whether a bank intends to keep them for a short period or a longer one. A valuation-based approach would *"align the design and structure of regulatory capital requirements with the risks posed to a bank's regulatory capital resources. Fundamental to this proposal [is] a view that capital requirements for market risk should apply when changes in the fair value of financial instruments, whether recognised in earnings or flowing directly to equity, pose risks to the regulatory and accounting solvency of banks."*⁵

We note that this option was considered by the Basel Committee during the consultation phase but did not ultimately make it into the final standard.

When a position taken by an investor experiences market changes, then he or she might revise his or her strategy towards them, which means that market risks can influence the length of the trading holding period, and not the other way around. Indeed, an investor's trading intent will impact the risks he or she is willing to take, but not the risks he or she really faces, which solely depend on markets.

Another weakness of an intent-based definition is that it will always lead to ambiguity and lower comparability, as it will be subject to as many interpretations as there are investors. This will in turn cause extra work for the supervisor to verify the legitimacy of each interpretation, and might eventually lead to miss-booking. An accounting-based methodology is on the contrary easier to supervise and more objective. It would give more weight to auditors and pressure them to exercise more scrutiny, which would benefit the whole sector and help restore confidence if the power of interpretation is reduced and aligned with financial accounting statements.

We fully support BCBS's proposal to remove any benefit from switches between books, as this is indeed the only way to ensure that no regulatory capital arbitrage can result from a switch, as long as switches are not completely forbidden. In the past,

this latitude has encouraged firms *“to push non-performing trading book holdings to the banking book, thereby reducing the amount of required capital cover by 80% moving from an 8% capital cover requirement to 1.6% capital cover”*⁶ rendering necessary the adoption of strict measures removing any incentive for arbitrage.

We also support keeping the requirement for mandatory approval by the supervisor regarding special derogations, such as a demand for a different allocation than the one following the standards set by BCBS. This approval should be explicit and should not consider a “no response” as a green light, as the industry pushes for. This would prevent requests that get overlooked because of insufficient resources at the supervisor from being passed as wrong approvals for the industry.

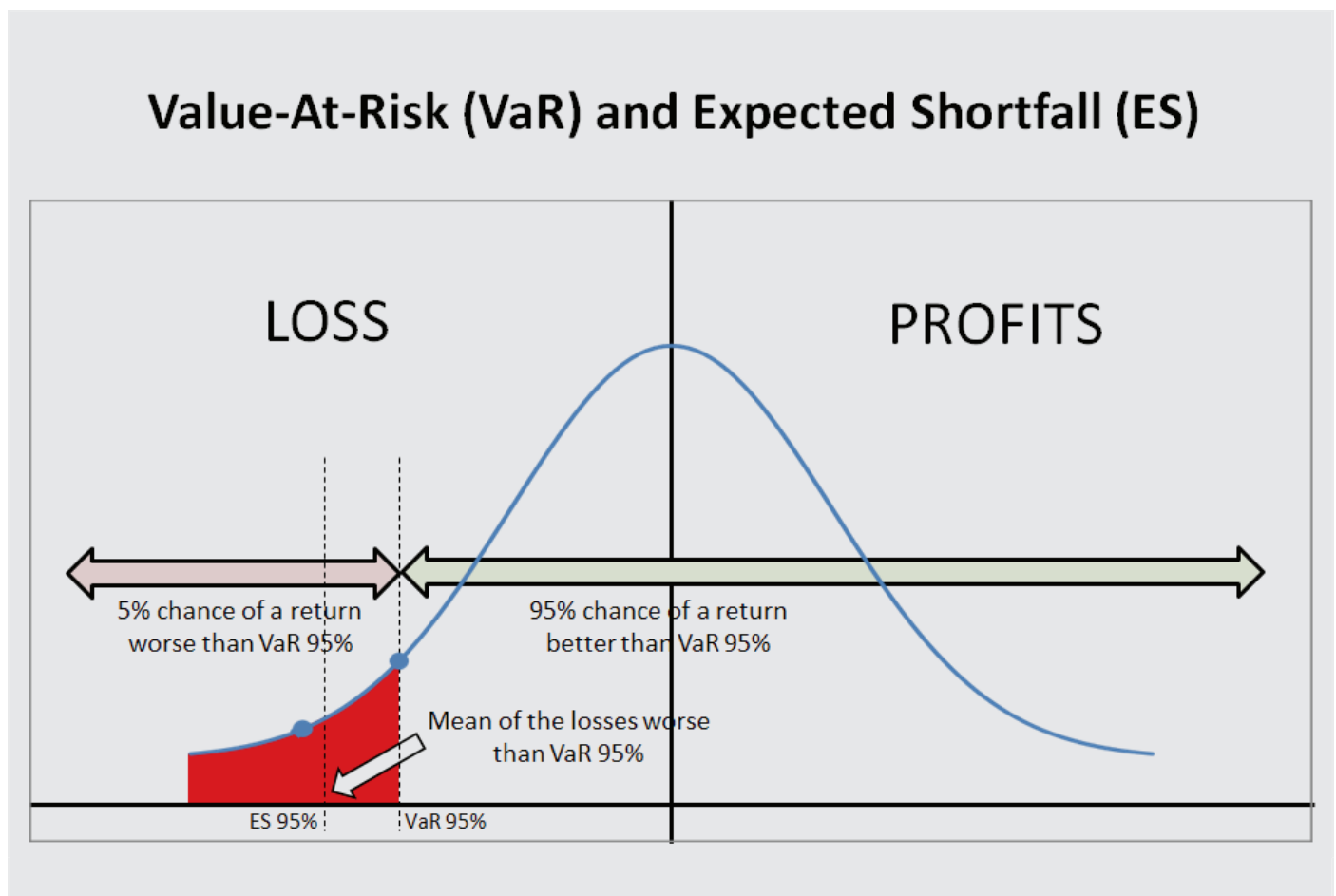
II. Expected shortfall: A superior risk metric, though still illusory

A. DEFINITIONS OF VAR AND EXPECTED SHORTFALL

The Value at Risk, or VaR, is a statistical figure that gives the amount of loss one can expect at a given confidence level over a given period of time. As an example, a Value-at-Risk within a 90% confidence interval over one year is the maximum expected loss in 90% of scenarios over one year. This figure does not however tell anything about the expected loss in the 10% remaining extreme scenarios. It replaced volatility as a risk measure during the '90s and was officially introduced as an amendment to the Basel Accord in 1993 in order to set banks' capital requirements. Indeed, banks were required to hold enough capital to cover 10 days of potential losses based on a 95% 10 days VaR, multiplied by a scaling factor

ranging from one to three times. VaR has allowed banks to describe their worst case scenario by using a simple single figure, which explains its popularity and wide use amongst all financial players.

The Expected Shortfall is another statistical risk measure, also referred to as conditional VaR, that gives the expected (or average) loss of a portfolio above a given confidence level. Thus, the Expected Shortfall, contrary to the VaR, gives an idea of the magnitude of the possible losses in the tail of the distribution (extreme scenarios), which makes it superior to VaR since it gives extra information. Basically, the VaR will provide the lowest losses that can happen in the worst case scenarios, while expected shortfall will give the average loss that happen in those worst case scenarios.



B. WHAT IS THE RATIONALE FOR THE CHANGE?

Although VaR has been a very popular and widely used metric over the past decades, it has some serious drawbacks that have been often criticized, especially since the subprime crisis. In particular, VaR is known to be an incoherent risk measure since it is not sub-additive. That is, the VaR of two portfolios grouped together can sometimes exceed the sum of the VaRs of the two distinct portfolios, meaning that the risk measure does not properly take into account the principle of diversification.

Another drawback of VaR concerns its nature, namely a mere quantile, which therefore does not give any information regarding the magnitude of the possible losses in the tail of the distribution, beyond the confidence level. This proved to be misleading during the financial crisis and led to an underestimation of potential extreme losses. This is why many stakeholders are now using Expected Shortfall internally as their risk measure. Indeed, the Expected Shortfall has the advantage over VaR of being a coherent measure, therefore sub-additive, and gives information regarding the magnitude of potential losses that can happen in the tail of the distribution. The Basel Committee is following this trend and getting up to date by adopting this more reliable risk measure.

C. FINANCE WATCH'S VIEW

Finance Watch welcomes the change of metrics from VaR to Expected Shortfall since the Expected Shortfall better captures extreme losses and is unanimously considered to be superior to VaR. Nonetheless, we remain sceptical that a single mathematical measure can be a proper and effective risk management tool. Indeed, as mathematical statistics professors Rootzén and Klüppelberg already explained 16 years ago⁷, *“a single number cannot hedge against economic catastrophes”* since *“it cannot capture all the different aspects of catastrophic financial risk”*, and *“the final comprehensive picture of financial risk would be to have the joint distributions of the possible losses at many different levels of aggregation and time horizons”* with methods developed from statistical extreme value theory. Our main concern regarding Expected Shortfall is that stakeholders over-rely on it without bearing in mind the limited and specific information it contains, as was the case with VaR.

Another source of concerns relates to the measure's utilization and specifically its calibration. Even if, theoretically, Expected Shortfall is a useful measure of risk, it is crucial that it is properly calibrated. In particular, the risk measure not only needs to be calibrated using current market figures, but also stressed ones, in order to properly reflect periods of significant market stress. In this respect we also agree with the BCBS that the observation horizon must go back at least to 2007 and represent the most severe 12-month period of stress available. Although the industry might argue that requiring these data is not necessary and burdensome, we strongly believe otherwise. Indeed, any mathematical measure has to be intensively backed by historical data and appropriate risk scenarios in order to be relevant and give a proper sense of the potential risks that are being taken.

The confidence level at which the Expected Shortfall is calculated is also an important parameter to take into account. Indeed, a choice of high quantile levels like the current 99% for VaR can lead to considerable estimation error and model risk, increasing operational risk. On the other hand, if pitched too low it can lead to understating capital requirements. This is why a confidence interval of 97.5%, as BCBS is proposing, seems to be the appropriate balance between these two risks.

III. New standardised approach: A failed balance between risk sensitivity, simplicity and comparability

A. THE CURRENT STANDARDISED APPROACH

Currently, capital requirements for market risk under the standardised approach are based on specific fixed risk weights depending on different parameters such as the regional exposure, the duration or the credit assessment of the instrument, for instance. The standardised approach applies by default to any bank that does not have an internal model or has not obtained authorisation from its supervisor to use its internal model. It is therefore aimed, in particular, at smaller banks that do not have the capacity to develop their own sophisticated models and provides a basic framework for banks to calculate their capital requirements in a standardised manner.

B. THE PROPOSED FUTURE STANDARDISED APPROACH AND THE RATIONALE FOR IT

The standardised approach is being revised in the fundamental review of the trading book by the Basel Committee in order to obtain the right balance between risk sensitivity, simplicity and comparability. As the original standardized approach was already very simple and comparable, we understand the objective to mean mostly more risk sensitive and granular.

This approach is aimed at being a credible fall back solution when internal models do not get the green light from the supervisor. Moreover, the Basel Committee aims to make standardised approach calculations mandatory for all banks in order to facilitate comparisons between them, and it might use those results as a floor or surcharge to calculations obtained with banks' internal models. This proposal to expand the use of the standardized approach might explain in part why the standardized approach is being reviewed to make it more risk sensitive and aligned with industry practices: this could quell large banks' recriminations in case the results of the new standardized approach show significant discrepancies with their internal models.

For that purpose, the revised standardised approach will be based on sensitivities rather than cash-flows, meaning that prices and sensitivities calculated by the banks themselves will be used to calculate capital requirements instead of separating instruments into their constituent cash-flows discounted with the appropriate risk curve. This approach, pushed by the industry, enables banks to use their existing pricing and sensitivity models, therefore reducing potential additional costs from building parallel systems to store the cash-flow information needed for the calculations.

Furthermore, the framework authorizing the use of internal models has been revised: under the new, more granular methodology supervisors can grant the authorization to use internal models to some individual desks and not others. Indeed, the concept of a trading desk, which is defined as *“a group of traders or trading accounts that implements a well-defined business strategy operating within a clear risk management structure, defined by the individual bank but subject to supervisory approval”*⁸, is being introduced in the revised trading book review, and approvals to use internal models will be authorized at this level, meaning that the supervisor can grant one desk the use of an internal model while requiring another one to use the standardised approach, if it judges it necessary.

C. FINANCE WATCH'S VIEW

We support the Basel Committee's initiative to give more significance to the standardised approach, especially by making its calculations mandatory for all banks, which will simplify comparisons and supervision. Yet, we are doubtful that the changes proposed are going in the right direction since they make the standardised approach too similar in our view to the internal model-based approach.

We have doubts, more generally, that there is a genuine need for two, if not three, different approaches (standardised, foundation and advanced IRB) to assess risk in one and the same industry. It was the stated purpose of the risk-sensitive capital adequacy regime at the outset to level the playing field among banks, account for different business models with different risk profiles and provide more transparency to investors. Today it is very difficult to see how any of these objectives are served by the current "pick and mix" approach. At best, it invites regulatory arbitrage and materially tilts the playing field in favour of the largest players; at worst, it allows banks to cover the inadequacy of their balance sheets behind a screen of smoke and mirrors, only to be exposed by the next crisis

We are concerned that risk management tools are being wrongly used as regulatory and supervisory tools. Indeed, sophisticated models that are highly sensitive must be used by banks to choose which strategy to adopt, depending on the reward they are expecting and the risks they are willing to take. But those same models cannot be seen as effective when it comes to risk regulation, since using them would lead to risk micro-managing and would engage supervisors in a lost battle against more experienced and better equipped analysts who will outnumber them⁹. The financial sector is such a quick and innovative sector that any "sensitive" approach would rapidly become obsolete and would have to be regularly revised in order to adapt to new discoveries and trends in modelling and products. This is why we believe that risk regulation should rather focus on simple and robust aggregate risk metrics, such as, among others, the leverage ratio, in order to use them as credible and effective backstops or floors and to prevent banks from excessive risk taking.

We are also worried that the bottom-up philosophy proposed by the Basel Committee, with the introduction of trading desk-based model approvals and calculations, will be misleading and dangerous. Indeed, the granular approach, as detailed and exhaustive as it is, always entails illusory refinements and approximations since it supposes that risk is in its essence linear and that we can divide it into several components (depending on the market risk category, the instrument and the "modelability" of the risk) and then sum them up later without removing crucial information, ending up with at best an aggregate figure impossible to clearly interpret, and at worst with a wrong one. As the Turner review¹⁰ pointed out in its analysis of the subprime crisis, excessive reliance on sophisticated mathematical models was more dangerous than merely accepting that certain risks cannot be properly modelled, because it gave supervisors and top management an **illusion of safety** that led to catastrophic outcomes: *"The very complexity of the mathematics used to measure and manage risk, moreover, made it increasingly difficult for top management and boards to assess and exercise judgement over the risks being taken. Mathematical sophistication ended up not containing risk, but providing false assurance that other prima facie indicators of increasing risk (e.g. rapid credit extension and balance sheet growth) could be safely ignored."*

Although the Basel Committee made it one of its objectives to find the right balance between risk sensitivity, simplicity and comparability, we think that risk sensitivity has been too much taken into account, and in consequence, has led to too much complexity and will confuse comparability. The granular approach associated with overly detailed and risk sensitive calculations even creates distortions in the way risk weights are interpreted: while in the banking book, capital requirements are easily calculated by simply multiplying risk weights by minimal capital ratios, the interpretation of risk weights in the trading book will be different. *"Risk weights are more analogous to a gross standalone capital requirement for a particular asset. [...] For example, a trading book asset may have a 50% risk weight but, when diversified and hedged, the net capital requirement may only be 10%."*¹¹

IV. Illiquidity, diversification and endogenous risks

A. PROPOSED CHANGE AND RATIONALE

From a regulatory perspective, trading book positions have always been considered as liquid, as opposed to banking book positions which were supposed to be more illiquid. This is why the assumption that the bank could exit or hedge any trading book position within 10 days has been made so far. Unfortunately, reality has contradicted this assumption many times, and after incorporating add-ons for default and credit migration risk in its Basel 2.5 package in response to the 2009 crisis, the Basel Committee is now revising its 10-day horizon liquidity into a more granular assessment of liquidity horizons. Depending on the category of the instrument, the time required to exit or hedge a risk position in a stressed market environment without materially affecting market prices will range from 10 days to one year. This will bring the liquidity assumption closer to reality, and will also positively reduce arbitrage opportunities between the banking and trading books.

The Basel Committee also aims at better taking into account hedging and diversification effects in the standardised approach. At present, under the standardised approach banks may only recognise perfect or near-perfect hedges since correlation factors are determined by the regulator. Conversely, there are currently no strict rules for recognizing the risk-reducing benefits of hedging and diversification when banks calculate their capital requirements with an internal model since correlation parameters are set by the bank itself. The Committee's ambition is therefore to reduce this differential treatment by recognizing hedges if they are likely to prove effective during periods of stress through the use of mitigants. Once again, the idea is to better align internal model-based calculations with the standardised approach.

B. FINANCE WATCH'S VIEW

Finance Watch supports the Basel Committee's intentions of revising its market risk framework in order to better assess risks that are being taken by banks but believes that trying to align calculations with industry practices is not the right solution, especially regarding systemic concepts such as market liquidity and diversification, which cannot be assessed on an individual level. Indeed, "while individual banks might judge that they can all promptly exit or hedge their risk exposures without affecting market prices, the market is likely to turn rapidly illiquid in times of banking stress if the banking system as a whole holds similar exposures."¹²

Systemic risks cannot be treated on a granular and individual level, since they not only depend on the positions banks take and the risk categories of the instruments they trade, but are inextricably linked to the global positions, behaviours and interconnectedness of the industry as a whole. This is why those risks should be regulated on a macro-prudential basis rather than on a micro-prudential one.

Micro-prudential regulation is not only unfit to capture systemic risks but even magnifies them since imposing similar risk models amongst banks will inevitably lead to similar strategies, especially exit ones, which will deepen any on-going crisis. As many academics¹³ correctly explain, market risk is endogenous, meaning that forecasts and predictions of future market risks will directly influence future market risks, unlike weather forecasts, for instance, which will have no impact on what the weather is really going to be. This is why regulators have to be very cautious with measures that could create herding and pro-cyclical behaviours and should rather focus on broad and simple metrics which will not distort market participants' individual conducts the same way but on the contrary allow them to have a diversity of views about risk.

Finance Watch believes that micro-managing risk is dangerous and unnecessary if the right regulations are put in place. Indeed, if banks truly faced the consequences of their excessive risk-taking behaviour, they would themselves adopt prudent and strong risk management practices. This is why working to curb moral hazard should remain a priority and more work should be carried out on topics like bank structural reform, a credible resolution mechanism and curbing interconnectedness.

Conclusion and recommendations

Finance Watch supports the Basel Committee's revision of the market risk framework for the trading book, as it is a long overdue initiative, whose importance has been amplified since the financial crisis. Although we share the intentions of the Committee to better regulate the trading book and fully support some of its propositions, we remain doubtful about some of its other propositions.

First, we believe that the banking and trading books should be defined based on accounting standards, and not on intentions, since it is the only truly objective way to differentiate them. We also believe that regulatory arbitrage opportunities have to be removed and in this respect fully support the Committee's proposal to eliminate any benefit that could be obtained after a switch. We are also concerned with the industry's push to remove mandatory explicit approvals regarding an instrument's allocation to the trading book, as this could end up with overlooked requests being falsely passed as approved.

Secondly, we share the Committee's and the industry's willingness to change its current risk metric, VaR, to Expected Shortfall, which is undoubtedly superior, but we are worried about the dangers of relying too much on a single mathematical measure. Furthermore, regarding the issue of stressed calibration, we would like to emphasize the importance of using all data available, and fighting against shortcuts motivated by alleged additional operational costs.

Thirdly, we disagree with the direction taken by the Committee over the standardized approach, as we believe that the more sensitive and granular approach being proposed adds unnecessary complexity and dangerous opacity to the final figures. On the contrary, we should rather promote the use of simple and robust aggregate risk measures, which would better stand the test of time and not lag behind industry practices. It would appear that one unified approach to risk-sensitivity, i.e. a true Standardised Approach, should be more than sufficient, in addition to risk-neutral metrics, such as the Leverage Ratio, the Liquidity Coverage Ratio and the Net Stable Funding Ratio,

to provide for an effective, balanced and transparent micro-prudential framework.

Lastly, but not least, we agree with the Committee that liquidity risk and the benefits of diversification are systemic concepts. Therefore, we believe that they should not be treated on an individual basis but instead through the use of macro-prudential regulations. Not only do we think that micro-regulating such systemic risks is inadequate, we are also concerned that it is fostering a unique vision of risks, creating herding and pro-cyclical behaviours that will amplify future crises. Limiting interconnectedness, ring-fencing trading activities and suppressing moral hazard have to be the true priorities in order to bring stability to the financial system.

FOOTNOTES

1. "Minimum capital requirements for market risk" (January 2016): <http://www.bis.org/bcbs/publ/d352.htm>, "Fundamental review of the trading book: outstanding issues - consultative document" (December 2014): <http://www.bis.org/bcbs/publ/d305.htm>, "Fundamental review of the trading book - second consultative document" (October 2013): <http://www.bis.org/publ/bcbs265.htm>, "Fundamental review of the trading book - consultative document" (May 2012): <http://www.bis.org/publ/bcbs219.htm>
2. The Basel Committee on Banking Supervision (BCBS) includes 45 members from all around the world (<http://www.bis.org/bcbs/membership.htm>). Their objectives are to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. The committee is located in Basel, Switzerland, and therefore usually referred as the Basel Committee and its recommendations as Basel Accords. The Committee only has the power to issue recommendations ("soft law").
3. The Expected Shortfall is a risk measure alternative to the Value-at-Risk providing more information on potential losses in the case of extreme scenarios. (See Section II for further details)
4. For instance, any instrument held for short-term resale, profiting from short-term price movements, or locking in arbitrage profits belongs to the trading book, whereas unlisted equities or equity investments in a fund not quoted daily belong to the banking book.
5. Basel Committee on Banking Supervision (October 2013). Fundamental review of the trading book: A revised market risk framework.
6. Wolters Kluwer Financial Services (2015). Fundamental Review of the trading Book, Are you covered?
7. Rootzen, H. and Klüppelberg, C. (1999). A single number can't hedge against economic catastrophes. *Ambio*. 28 (6), 550-555. Royal Swedish Academy of Sciences.
8. Basel Committee on Banking Supervision (October 2013). Fundamental review of the trading book: A revised market risk framework.
9. SSM officials mentioned at a conference in 2015 that it would take the ECB ten years to review all the existing risk models of the banks under its supervision.
10. Financial Services Authority (March 2009). The Turner Review, A regulatory response to the global banking crisis
11. Basel Committee on Banking Supervision (October 2013). Fundamental review of the trading book: A revised market risk framework.
12. Basel Committee on Banking Supervision (October 2013). Fundamental review of the trading book: A revised market risk framework.
13. Danielsson, J., P. Embrechts, C. Goodhart, C. Keating, F. Muennich, O. Renault, and H. S. Shin (2001). An academic response to Basel II.

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About Finance Watch

Finance Watch is an independently funded public interest association dedicated to making finance work for the good of society. Its mission is to strengthen the voice of society in the reform of financial regulation by conducting advocacy and presenting public interest arguments to lawmakers and the public. Finance Watch's members include consumer groups, housing associations, trade unions, NGOs, financial experts, academics and other civil society groups that collectively represent a large number of European citizens. Finance Watch's founding principles state that finance is essential for society in bringing capital to productive use in a transparent and sustainable manner, but that the legitimate pursuit of private interests by the financial industry should not be conducted to the detriment of society. For further information, see www.finance-watch.org



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