



Fundamental Review of the Trading Book in Industry Update

Progress made, but many questions remain

Prioritise those efforts that provide significant benefits that are FRTB timing agnostic

KPMG has been sounding out banks on the impact of the Fundamental Review of the Trading Book ('FRTB'). It's complex, potentially (very) costly and has a number of grey areas that are creating a significant degree of uncertainty across the industry.

At KPMG, we wanted to understand – 15 months after the publication of the final requirements by the Basel Committee – how banks are dealing with this regulatory burden, their approach to tackling the challenge in the face of the remaining uncertainty and emerging leading market practices.

Based on our conversations with clients and using live polling from the recent Infoline FRTB Summit⁽¹⁾, we have observed banks making significant strides in relation to implementation programmes and creating awareness across their organisations. However, digging deeper has revealed a mixed picture.....

Up and running?

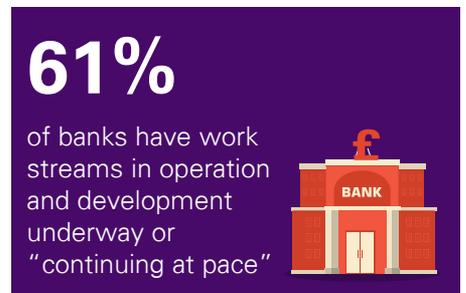
Encouragingly, only a very small fraction of banks have not yet started to tackle FRTB, and approximately 60% of banks have their projects well underway despite the unanswered questions that remain. Implementation costs on average may be less than originally feared (a year ago our G-SIB clients told us this would be approx. \$100-150m) potentially as a result of banks having had the opportunity to review the totality of the requirements. However, we observed significant variation between the high and low estimates, with approximately 20% of banks expecting to spend over \$100m.

Against the clock

Most of our live polling respondents expect the implementation date to be 2021 (or sooner in some cases), which is in line with our current expectations of the go-live date for the market risk requirements in the CRR2 in Europe – which in turn will begin a 3 year phase-in and monitoring period. Only 3% of the respondents expect FRTB to be mothballed.

We expect both the UK PRA and the EU27 market risk capital regimes to be in close alignment. Although the future of US bank regulation is uncertain, any non-US based legal entities of a US bank would be subject to local supervision and associated capital requirements. If significant fragmentation does occur in the implementation of FRTB across major jurisdictions this will be the 'worst case' outcome. Running multiple processes, calculations and maintaining legacy infrastructures throughout a fragmented implementation would be extremely challenging.

Note ⁽¹⁾: <https://finance.knect365.com/frtb-london>



Standardised versus Internal Model capabilities

Approximately 40% of banks expect to have a fully operational standardised approach by the end of 2018, which provides ample time to assess how the impacts of the standardised method evolve as exposures and markets change in the run up to go-live. For the IMA method that window is much shorter, but not surprising given the implementation and data complexities and uncertainties that remain around this aspect of the requirement. It is the view from approximately half of the respondents that the proposed 35% haircut to market risk capital requirements for the three year phase-in period (as in the CRR2 draft) will relieve pressure on timelines for their IMA roll out. Interestingly, a significant number (23%) view the haircut as an opportunity to expedite IMA and achieve lower capital requirements over the phase-in period, thereby increasing risk adjusted capital returns on a relative basis in the near-term.

Trading desks and capital floors

The structure of a bank's trading operations will play a critical role in determining the final market risk capital requirement through its impact on eligibility testing (desk level performance) and on the subsequent aggregation of IMA and SA capital requirements (loss of diversification between IMA and SA methods).

Almost half of respondents are still considering how to tackle the desk structure conundrum, with an equal number expecting to pursue a globally consistent trading desk hierarchy. The latter may be difficult to achieve in practice given the varying nature of operations across geographies and the necessity of obtaining local supervisory approval for an entity's desk structure.

The much-maligned capital output floor will be a key driver of the final market risk capital requirement. Bankers expect this to be set lower than the 75% proposed by the Basel Committee – but there will still likely be a significant uplift in the overall capital impact. The most frequent response was an expected aggregate floor in the range of 60-65%.

Shaping the future

FRTB lacks clarity on a number of important aspects and still has challenging implementation timelines in spite of the delays to implementation dates – key areas that are still being debated include eligibility testing, non-modellability and the boundary between the trading and banking books.

With these grey areas in the requirements and also the uncertainty remaining around national regulations, there is still the opportunity for the industry to influence the final legislation – indeed, the respondents to our polling informed us that the aspect they would most like to remove would be non-modellable risk factors ('NMRFs').

Conclusion and next steps

We should not lose sight of the big picture. Whilst on a stand-alone basis the impacts on market risk capital are material (56% of respondents expect the impact to exceed the latest Basel III monitoring impact of 76%) in comparison to the other Basel 4 changes the impact on risk weighted assets is relatively small for most banks. The two most important issues with FRTB are:

- 1) The cliff effect between IMA and standardised and the volatility it will introduce to the risk returns for trading operations; and
- 2) The huge implementation and operational efforts required just to meet the new requirements which are materially greater than any of the other Basel 4 changes.

Our view is that there will likely be some form of relief on both NMRFs and the eligibility tests. Allowing for NMRFs to be capitalised under the Pillar 2 framework could be a compromise that is acceptable. On eligibility tests, rather than implementing a binary 'in/out' of the internal model framework, there could be the introduction of a monitoring or grace period over which banks have a window of opportunity to tackle modelling, data or other issues that are creating the break.

We are increasingly being asked by clients what actions should be taken in light of the uncertainty that still remains. We are advising our clients to prioritise efforts on those aspects of the requirements that are good practice and represent "no regrets" choices, such as:

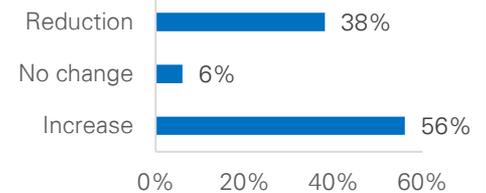
- (a) data cleansing and alignment (FO and Risk) including product/risk factor taxonomies (aids BCBS 239);
- (b) enhancing model governance and understanding modelling differences across FO, Risk and Finance (aids MRM and TRIM);
- (c) assessing regulatory and other programme overlaps and potential efficiencies (e.g. IFRS9);
- (d) develop roadmaps for implementation and the potential operating model to aid accelerated roll out;
- (e) standardised modelling capabilities; and
- (f) build out secondary considerations and effects, such as capital allocation.

60-65%

Expected range of the capital floor



Will the final impact on market risk capital requirements be smaller / larger than the latest Bill monitoring report (up 76%)?



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