Liquidity squeeze

Osmo Timonen, an expert in bank regulation at management and technology consultancy BearingPoint, discusses the likely impact of the Fundamental Review of the Trading Book on the secondary ABS market

Since 2012, the Basel Committee on Banking Supervision has been working on a major overhaul of market risk capital requirements for banks´ trading-book positions. The regulatory initiative - entitled the Fundamental Review of the Trading Book (FRTB) - will increase regulatory capital requirements and, as a result, drive up the cost of trading. The secondary market for securitised products is on the line for a potential liquidity squeeze, as banks engaged in market making will have to reassess their business practices.

At this point, the timeline for the coming changes is still open. Authorities are now completing a study phase on the feasibility of the proposed new rules. Most likely, decisions about new requirements will be made by the end of 2015, with requirements for implementation set for 2018.

One of the main goals of the FRTB is to address inconsistencies in the current regulation for market risk. A 2012 study of the Basel 3 implementation, the Regulatory Consistency Assessment Program (RCAP), revealed that banks report widely different risk exposures for similar portfolios. One key driver of inconsistent reporting was trading book market risk requirements.

The FRTB will completely transform current market risk models. Banks can now choose whether to follow the standardised approach to count their risk exposures or, if they prefer, use internal models. Internal models require more resources, but often result in a favourable understanding of exposures to risk-weighted assets. This gives big banks with more resources an advantage over their smaller peers.

The existing standardised approach for market risk will be replaced by a ‘sensitivities-based standardised approach’ that all banks will be required to model. The internal model approach will face a complete overhaul that includes replacing the widely used Value-at-Risk model with a new Expected Shortfall calculation. According to the Basel Committee´s working proposal, the new

sensitivities-based standardised approach should be used as a floor for capital requirements, effectively removing the advantage of using internal models.

The regulatory initiative also aims to reduce regulatory arbitrage between the banking book and the trading book, with a new, stricter definition of the boundary between the two books. In essence, the decision about which products belong to the trading book would no longer depend on banks' perceived intentions to trade, but rather on preset criteria provided by the regulators.

All these new rules will increase capital requirements, particularly for trading book institutions that currently rely on internal models for market risk calculations. The banking industry has been gradually signaling growing concern about the coming changes.

Three major bodies that represent the banking industry globally - ISDA, the Global Financial Markets Association and the Institute of International Finance - have joined forces in an attempt to raise regulators' awareness of the systemic risks that further decreases in market depth can cause. They point out that the increased costs of trading will likely be passed on to customers. If the cost of trading goes up, some market participants might choose not to hedge their risks, which raises the chances of increased market volatility.

In particular, the FRTB is likely to impact the secondary market of securitised products. From a regulatory point of view, banks that act as market makers in the secondary market enter temporary risk positions in their trading books.

As the regulatory capital costs for market making increase, trading desks are likely to curb their activities by pulling out completely or by widening the bid-ask spreads and decreasing the immediately available volume. This would most likely result in worse investment conditions for the buy-side and a less efficient market.

A regulatory paradox is clearly in play with the FRTB. By making banks safer on an individual basis, regulators will impact the liquidity of financial markets on a global scale. Structured credit professionals can only hope that the Basel Committee pays attention to the concerns the banking industry is now voicing.

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