Basel IV & CRR II: Revised Standardised Approach for Market Risk

Increasing risk sensitivity due to the “Sensitivities-based Approach”
Preface
The revisions to the existing regulatory framework are focusing on determination of risk weighted assets.
The FRTB addresses material weaknesses of the current market risk framework exposed by the financial crisis …
… and aims to replace the existing regulation and harmonises the treatment of market risk across national jurisdictions.
FRTB as part of CRR II – sizing up the trading book.
The FRTB introduces several enhancements to the existing framework.

FRTB Framework: Sensitivities-based Approach
The revisions to the standardised approach (Sensitivities-based Approach) aim to increase risk sensitivity.
Sensitivities-based Method Definitions that cover the main concepts.
FRTB framework uses seven risk classes.
Linear risks within the Sensitivities-based Method are captured with delta and vega risk factors.
Non-linear risks within the Sensitivities-based Method are captured with the curvature risk factor.
The final risk charge for the Sensitivities-based Method is determined based on three correlation scenarios ................................................................. 28
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Typically substantial regulatory changes can be challenging for institutions ........................................................................................................ 38
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With the tool we are able to do the necessary calculations for the standardised approach ...................................................................................... 43
Starting in 2012, the Basel Committee published several consultation papers on a fundamental review of the trading book (FRTB) to adapt existing rules for the capitalisation of market risk to the lessons learned and shortcomings that became evident during the financial crisis. This fundamental review covers all aspects of minimum capital requirements for market risk such as the trading book – banking book boundary, the standardised approach as well as the use of internal market risk models.

Among the proposed changes, none has more profound impacts than the revised standardised approach – the so called Sensitivities-based Approach. In fact, it is less a standardised method than an internal model approach, developed by the supervisors. It leads to an enormous increase in data requirements and complexity of calculations compared to the current approaches. And it will also have a significant impact on risk weighted assets, especially with regard to positions subject to optionality or credit spread risks.

On 23 November 2016, the EU Commission has proposed amendments to the capital requirement directive and regulation. The amendments will – beside others – introduce more risk sensitive measures. The European Commission has adopted the FRTB framework in the CRR II, that according to the Basel Committee has a final status since January 2016.
With regard to the standardised approach for market risk, the European Commission kept the proposed Sensitivities-based Approach developed by the BCBS with only minor changes. The most essential change to the FRTB framework is connected to the principle of proportionality. This means that the EU acknowledges the contradiction of the new requirements with the risks taken by institutions with medium sized trading books. Therefore, medium trading book institutions are allowed to apply a “Simplified Standardised Approach”. Thus, they can further on determine the capital requirement for market risk using the existing standardised approach.

This brochure will help you gain an overview over the proposed rules to prepare for the tasks ahead.

Kind regards,

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Global Basel IV Leader

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Global Basel IV Standardised Approach Workstream Leader
The revisions to the existing regulatory framework are focusing on determination of risk weighted assets

The Basel III framework has focused mainly on banks’ own funds requirements. Currently, the Basel Committee on Banking Supervision (BCBS) is in the process of revising the standardised approaches for calculating minimum capital requirements. The industry already summarises these revisions under the term “Basel IV”. While the BCBS has not yet officially recognised this term the outcome is very clear: The revisions will have a fundamental impact on the calculation of risk weighted assets and capital ratios of all banks regardless of their size and business model. Beside FRTB, the European Commission has adopted further parts of the Basel IV package (SA-CCR or CVA) within their proposed amendments to the CRR.

Fig. 1 Areas of revision by the BCBS

<table>
<thead>
<tr>
<th>Capital requirements</th>
<th>Credit risk</th>
<th>Securitisation</th>
<th>Counter-party credit risk</th>
<th>Market risk</th>
<th>Operational risk</th>
<th>CVA risk</th>
<th>Step-in risk</th>
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</thead>
<tbody>
<tr>
<td>Capital floors</td>
<td>(BCBS 306,</td>
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<td>BCBS 362)</td>
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<td>Interest rate risk in the</td>
<td>(BCBS 368)</td>
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<td>banking book</td>
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<td>SA for credit risk</td>
<td>(BCBS 347)</td>
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<tr>
<td>Revisions to the securitisation framework</td>
<td>(BCBS 374)</td>
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<tr>
<td>SA counter-party credit risk</td>
<td>(BCBS 279)</td>
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<tr>
<td>Fundamental review of the</td>
<td>(BCBS 352)</td>
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<tr>
<td>trading book</td>
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<tr>
<td>Revisions to operational risk</td>
<td>(BCBS 355)</td>
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<tr>
<td>Review of the CVA risk</td>
<td>(BCBS 325)</td>
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<td>framework</td>
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<tr>
<td>Step-in risk</td>
<td>(BCBS 349)</td>
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</tbody>
</table>
The FRTB addresses material weaknesses of the current market risk framework exposed by the financial crisis ...

Fig. 2 The fundamental review of the trading book (FRTB): An Overview

“The financial crisis exposed material weaknesses in the overall design of the framework for capitalising trading activities.” (Basel Committee on Banking Supervision, October 2013)

<table>
<thead>
<tr>
<th>Material weaknesses of current approaches ...</th>
<th>... require fundamental review</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treatment of credit risk in the trading book</td>
<td>1. Additional tools for supervision</td>
</tr>
<tr>
<td>Weaknesses of VaR approach</td>
<td>2. New <strong>standardised approach</strong> increases risk sensitivity of RWA calculation</td>
</tr>
<tr>
<td>Hedging and diversification</td>
<td>2. Marked increase of complexity</td>
</tr>
<tr>
<td>Liquidity of trading book positions</td>
<td>3. <strong>Internal models approach</strong> using Expected Shortfall (ES) instead of Value-at-Risk (VaR)</td>
</tr>
<tr>
<td>Transparency and comparability of RWA</td>
<td>3. Changes to model approval process</td>
</tr>
<tr>
<td></td>
<td>3. Floor based on standardised method</td>
</tr>
</tbody>
</table>
During the financial crisis it turned out that the regulatory capital for market risk was not adequate. Therefore, the Basel Committee on Banking Supervision has created with the fundamental review of the trading book (FRTB) a new framework to replace the old market risk regulation defined under “Basel II.5”. The intention is “to improve trading book capital requirements and to promote consistent implementation of the rules so that they produce comparable levels of capital across jurisdictions”.

### Fig. 3 Key objectives of the FRTB

The proposals reflect BCBS’s key objectives

- To develop an effective trading book/banking book boundary condition,
- to achieve a regulatory framework that captures and capitalises all market risks in the trading book,
- to improve risk measurement techniques and
- to achieve comparable levels of capital across internal risk models and the standardised approach.

BCBS’s proposals align with the key objectives of the EU Commission

- To build on the principle of proportionality and strengthen the resilience of EU banks,
- to introduce more risk-sensitive capital requirements as well as
- to further reinforce banks‘ ability to withstand potential shocks
The past and future of the trading book regime

1996 Basel I
First methodology laid out by the BCBS to set out capital requirements for market risks. The amendment to the Basel Capital Accord included a standardised approach and an internal models approach.

2004 Basel II
The amendment was further revised in 2005. The paper changed the trading book regime.

2009 Basel 2.5
First attempt by the BCBS to address the trading book issues revealed by the global financial crisis. Revisions to the Basel II market risk framework.

2012 FRTB
The BCBS issued the fundamental review of the trading book (FRTB) consultation paper.

2012–2015
Two more consultative papers and four quantitative impact studies.

2016 Revised standards
In January 2016 the Basel Committee on Banking Supervision (BCBS) published revised standards for minimum capital requirements for market risk.

2019
Expected entry into force of CRR II and BCBS’s deadline for local regulation in January 2019

2024
CRR II: End of phase-in period (three years after date of application), in which large trading book institutions are allowed to multiply their capital requirements by a factor of 65%.
The CRR II includes the EU implementation of the fundamental review of the trading book. In terms of methodologies for the own funds calculation approaches, CRR II broadly follows the Basel framework and adopts the revised approach proposed by the BCBS. The proposal introduces the new more risk sensitive standardised approach (SBA) and variations to the internal model approach (IMA). The new SBA includes the calculation of delta, vega and curvature risk. During a three year phase-in period, the European Banking Authority will review and report to the European Commission on the appropriateness of the FRTB framework.

Although CRR II does not indicate the use of SBA as a floor to the capital requirements under the IMA, discussions are still ongoing on this topic. While the capital add-on under the IMA will impact firms with certain exposures, the new residual risk add-ons under the SBA are also deemed to be capital intensive. The capital floors and add-ons are key drivers that firms should consider in adopting the IMA versus SBA for capital requirements calculation.
A significant change compared to the Basel framework is the derogation for small and medium size trading businesses, which CRR II introduces to address proportionality. Besides, there is a preferential risk weight for EU sovereigns and covered bonds for credit spread risk under the Sensitivities-based Method.

### Fig. 4 Overview FRTB application according to CRR II

<table>
<thead>
<tr>
<th>Size of Trading Book</th>
<th>On- and off-balance sheet trading book business</th>
<th>No market risk capital requirements, application of credit risk approaches</th>
<th>Permanent use of existing market risk standardised approach possible</th>
<th>FRTB approaches to be applied, multiplier of 65% during the first three years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Small Trading Book</td>
<td>≤ 5% of total assets</td>
<td>≤ 50 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Medium Trading Book</td>
<td>≤ 10% of total assets</td>
<td>≤ 300 million</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Large Trading Book</td>
<td>&gt; 10% of total assets</td>
<td>&gt; 300 million</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
## The FRTB introduces several enhancements to the existing framework

### Fig. 5 Overview of the enhancements to the existing market risk framework

| Regulatory boundary between trading and banking book | • New defined list of instruments presumed to be included in the trading book or banking book. Deviation requires explicit approval from supervisor.  
• Strict limits on the movement of instruments between the books after initial designation. Should a re-designation be approved a capital benefit will not be allowed. |
|---|---|
| From VaR to ES | • The new risk measure for market risk according to FRTB is the Expected Shortfall (ES).  
• ES is a coherent risk measure, whereas Value-at-Risk (VaR) is not due to the missing sub-additivity feature.  
• Banks must calibrate the ES to periods of significant market stress.  
• This new metric will help to capture the tail risk and so maintain adequate capital during periods of significant market stress. |
| Revised standardised approach | • Significant changes with introduction of Sensitivities-based methodology.  
• The revised standardised approach will act as a floor to the internal models approach. |
| Inclusion of market illiquidity | • Varying liquidity horizons included in the internal models approach.  
• Replaces the static 10 day liquidity horizon currently assumed in the VaR framework. |
| Revised approach to approval for internal models | • Supervisors will review the use of internal models at desk level.  
• More rigorous model approval process using both qualitative and quantitative criteria. |
FRTB Framework
Sensitivities-based Approach
The revisions to the standardised approach (Sensitivities-based Approach) aim to increase risk sensitivity

The standardised approach minimum capital requirement is the sum of three components: Sensitivities-based Method and default risk charge provide the main risk factors which are supported by residual risk add-on to sufficiently cover market risks.
1. Sensitivities-based Method (Art. 325e – 325l CRR II)

**Delta**: A risk measure based on sensitivities of a bank’s trading book positions to regulatory delta risk factors.

**Vega**: A risk measure that is also based on sensitivities to regulatory vega risk factors to be used as inputs to a similar aggregation formula as for delta risks.

2. Default risk charge

(Art. 325w CRR II)

A risk measure that captures the **incremental risk** not captured by the delta risk of price changes in the value of an option.

3. Residual risk add-on

(Art. 325v CRR II)

A risk measure to capture **residual risk**, i.e. risk which is not covered by the components 1. or 2.

**CRR II**: additional adjustments i.a. for covered bonds

**CRR II**: RTS on definition of exotic instruments

- Calculation of three risk charge figures based on **three different scenarios** on the specified values for the correlation parameter (cf. slide 27).
- The approach how the total capital charge is aggregated differs between the proposals of BCBS and CRR II
- The bank must determine each delta and vega sensitivity based upon regulatory pre-defined shifts for the corresponding risk factors.
- Two stress scenarios per risk factor have to be calculated and the worst scenario loss is aggregated in order to determine curvature risk.
**Sensitivities-based Method**
Definitions that cover the main concepts

The main concepts of the Sensitivities-based Method are given by the supervisor. Especially the relevant risk classes differ in parts from the risk classes used in the current approach.
### Definition of seven risk classes for the Sensitivities-based Method:

<table>
<thead>
<tr>
<th>Risk class</th>
<th>GIRR</th>
<th>Equity</th>
<th>Commodity</th>
<th>FX</th>
</tr>
</thead>
<tbody>
<tr>
<td>CSR (non-SEC)</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>CSR (SEC)</td>
<td></td>
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<tr>
<td>CSR (CTP)</td>
<td></td>
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</tbody>
</table>

### Risk factor
- Variables (e.g. a given vertex of a given interest rate curve or an equity price) within a pricing function decomposed from trading book instruments
- Risk factors are mapped to a risk class

### Risk position
- Main input that enters the risk charge computation
- Delta and vega risks: sensitivity to a risk factor
- Curvature risk: worst loss of two stress scenarios

### Bucket
Set of risk positions which are grouped together by common characteristics

### Risk charge
- Amount of capital that a bank should hold as a consequence of the risks it takes
- Computed as an aggregation of risk positions first at the bucket level, and then across buckets within a risk class defined for the Sensitivities-based Method
**FRTB framework uses seven risk classes (1/2)**
GIRR, Equity, Commodity & FX

**Fig. 8 Overview of risk classes and corresponding risk buckets, risk weights and correlations (1/2)**

<table>
<thead>
<tr>
<th>Risk buckets</th>
</tr>
</thead>
<tbody>
<tr>
<td>GIRR (General interest rate risk)</td>
</tr>
<tr>
<td>Each bucket represents an individual currency exposure to GIRR</td>
</tr>
<tr>
<td>Equity</td>
</tr>
<tr>
<td>• Buckets are depending on market capitalisation, economy (emerging or advanced) and sector</td>
</tr>
<tr>
<td>• Total of 11 buckets (e.g. consumer goods and telecommunication)</td>
</tr>
<tr>
<td>Commodity</td>
</tr>
<tr>
<td>Eleven buckets are defined for commodity (e.g. energy, freight, metals, grains &amp; oilseed, livestock and other agriculturals)</td>
</tr>
<tr>
<td>Foreign Exchange (FX)</td>
</tr>
<tr>
<td>No specific FX buckets</td>
</tr>
</tbody>
</table>
### Risk weights

- **Risk weights (RW)** depending on vertices ranging from 0.25 years to 30 years
- Risk weights are ranging from 1.5% to 2.4%
- Differentiation between risk weights to equity spot price and equity repo rate
- Risk weights for equity spot price ranges from 55% to 70%
- The risk weights depend on the commodity buckets (which group individual commodities by common characteristics)
- Risk weights range from 20% to 80%
- A unique relative risk weight equal to 30% applies to all the FX sensitivities or risk exposures

### Correlations

- Correlations between two sensitivities are depending on equality of buckets, vertices and curves
- Correlations between two sensitivities for the same bucket (but related to different equity issuer names) are depending on market cap and economy and are ranging between 7.5% and 25%
- Correlations between two sensitivities (same bucket) are defined by a multiplication of factors related to commodity type, vertices and contract grade / delivery location
- A uniform correlation parameter equal to 60% applies to FX sensitivity or risk exposure pairs
### FRTB framework uses seven risk classes (2/2)

Credit spread risk (CSR)

**Fig. 9** Overview of risk classes and corresponding risk buckets, risk weights and correlations (2/2)

<table>
<thead>
<tr>
<th>Risk buckets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>CSR non-securitisation</strong></td>
<td>18 buckets defined based on credit quality and sector</td>
</tr>
<tr>
<td><strong>CSR correlation trading portfolio (CTP)</strong></td>
<td>The same bucket structure as for CSR non-securitisation applies</td>
</tr>
<tr>
<td><strong>CSR non-correlation trading portfolios (n-CTP)</strong></td>
<td>25 buckets defined based on credit quality and sector</td>
</tr>
<tr>
<td>Risk weights</td>
<td>Correlations</td>
</tr>
<tr>
<td>--------------</td>
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</tr>
</tbody>
</table>
| • Risk weights are the same for all vertices within each bucket  
  • Risk weights range from 0.5% to 12% | • Correlations between sensitivities within the same bucket are depending on names and vertices of the sensitivities, and related curves  
  • Separate rules for “other sector” bucket |
| • Risk weights are the same for all vertices within each bucket  
  • Risk weights range from 2% to 16% | The risk correlations are derived the same way as for CSR non-securitisation, but correlations based on curves differ slightly |
| Risk weights range from 0.8% to 3.5% | • Correlations between sensitivities within the same bucket and securitisation tranche are depending on names and vertices of the sensitivities, and related curves  
  • Separate rules for “other sector” bucket |
Linear risks within the Sensitivities-based Method are captured with delta and vega risk factors

The computational procedure for linear risks can be divided into the five calculation steps shown below. Delta and vega risk measures are based on sensitivities of bank’s trading book positions to regulatory predetermined delta and vega factors, respectively. These measures are used to calculate the minimum capital requirements for Sensitivities-based Method.
### Fig. 10 Overview of the computational procedure for the linear risk charge

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Supervisory formulae</th>
<th>Details</th>
</tr>
</thead>
</table>
| 1 Assignment of positions to risk classes, buckets and risk factors | ![Diagram](image1.png)                                                                 | - Delta and vega risks are computed using the same aggregation formulae on all relevant risk factors  
- Separate calculation (no diversification benefit recognised) |
| 2 Calculation of the risk factor’s sensitivities  | e.g. for GIRR: $s_{r_{kl}} = \frac{V_l(n_{kt}, 0.0001, x, y \ldots) - V_l(n_{kt}, x, y \ldots)}{0.0001}$ | - The sensitivities are defined by the supervisor  
- Sensitivities for each risk class are expressed in the reporting currency of the bank |
| 3 Calculation of weighted sensitivities per bucket via given supervisory RW | $WS_k = RW_k s_k$                                                                   | The corresponding RW are defined by the supervisor                                        |
| 4 Aggregation of weighted sensitivities per bucket | $K_b = \sqrt{\sum_k WS_k^2 + \sum_k \sum_{k \neq l} \rho_{kl} WS_k WS_l}$               | The risk position for bucket $b$, $K_b$, must be determined by aggregating the weighted sensitivities to risk factors within the same bucket using the corresponding prescribed correlation $\rho_{kl}$ |
| 5 Aggregation of capital charge on risk class level | ![Diagram](image2.png)                                                                 | - The risk charge is determined from risk positions aggregated between the buckets within each risk class  
- $S_b$ and $S_c$ are the sums of the weighted sensitivities in the corresponding buckets |
Non-linear risks within the Sensitivities-based Method are captured with the curvature risk factor

The computational procedure approach for non-linear risks can be divided into three calculation steps that are shown below. The curvature risk measure represents the incremental risk not captured by the delta risk of price changes in the value of an option.
### Finding a net curvature risk charge CVR\(_k\) across instruments to each curvature risk factor \(k\)

\[
CVR_k = -\min \left\{ \sum_i \left[ V_i \left( x_k \left( RW_k^{(\text{curvature})} \right) \right) - V_i(x_k) - RW_k^{(\text{curvature})} S_{ik} \right], \sum_i \left[ V_i \left( x_k \left( RW_k^{(\text{curvature})} \right) \right) - V_i(x_k) + RW_k^{(\text{curvature})} S_{ik} \right] \right\}
\]

- Only for risk positions with explicit or embedded options
- Two stress scenarios are to be computed per risk factor (an upward shock and a downward shock)
- The worse potential loss of the two scenarios, after deduction of the delta risk positions, is the outcome of the first scenario

### Aggregation of curvature risk exposure within each bucket using the corresponding prescribed correlation \(\rho\)\(_{kl}\)

- \((CVR_k, CVR_l) = 0\) if both \(CVR_k\) and \(CVR_l\) have negative signs
- In all other cases, \((CVR_k, CVR_l) = 1\)

### Aggregation of curvature risk positions across buckets within each risk class

\[
K_b = \sqrt{\max \left( 0, \sum_k \max(CVR_k, 0)^2 \right) + \sum_{k \neq l} \rho_{kl} CVR_k CVR_l \psi(CVR_k, CVR_l)}
\]

- \(\psi(CVR_k, CVR)\) is a function that takes the value 0 if \(CVR_k\) and \(CVR\) both have negative signs
- In all other cases, \(\psi(CVR_k, CVR)\) takes the value of 1

\[
RC_{\text{Curvature}} = \sqrt{\sum_b k_b^2 + \sum_{b \neq c} \gamma_{bc} S_b S_c \psi(S_b, S_c)}
\]

- \(\psi(S_b, S_c)\) is a function that takes the value 0 if \(S_b\) and \(S_c\) both have negative signs. In all other cases, \(\psi(S_b, S_c)\) takes the value of 1.
The final risk charge for the Sensitivities-based Method is determined based on three correlation scenarios

In order to address the risk that correlations increase or decrease in periods of financial stress, three risk charge figures are to be calculated for each risk class. This is done by using multipliers for correlation parameters $\rho$ (correlation between risk factors within a bucket) and $\gamma$ (correlation across bucket within a risk class).
According to Art. 325i of CRR II, the calculation of delta, vega and curvature capital requirements should be performed separately per risk class in all three correlation scenarios. The aggregation across risk classes is conducted per scenario and risk type. Thus, three scenario specific capital requirements for delta, vega and curvature risk are required to be calculated. The final Sensitivities-based Method capital charge is the sum out of the largest of the scenario-specific capital charges for delta, vega or curvature risk.
The default risk charge is intended to capture the jump-to-default risk

The default risk charge is independent from the other capital charges for CSR non-securitisations and securitisations in the standardised approach.

One prime modification of CRR II refers to the calculation of the Default Risk Charge (DRC). The DRC formula has been extended by an adjustment for derivative instruments which increases or reduces the full loss on the underlying instrument.
### Fig. 13 Overview of the computational procedure for the default risk charge

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Supervisor formulae</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1</strong> Calculation of gross JTD positions</td>
<td>e.g. for debt instruments:</td>
<td>The jump-to-default (JTD) risk is computed for each instrument separately. JTD risk is a function of notional amount (or face value) and market value of the instruments and prescribed Loss given Default (LGD) figures.</td>
</tr>
<tr>
<td></td>
<td>( JTD\text{long} = \max{LGD \cdot V\text{notional} + P&amp;L\text{long} + Adjustment\text{long} } )</td>
<td></td>
</tr>
<tr>
<td></td>
<td>( JTD\text{short} = \max{LGD \cdot V\text{notional} + P&amp;L\text{short} + Adjustment\text{short} } )</td>
<td></td>
</tr>
<tr>
<td><strong>2</strong> Calculation of net JTD positions</td>
<td>e.g. Non-securitisation: long bond position and short equity position to the same obligor</td>
<td>The net JTD risk positions are calculated by using specified offsetting rules.</td>
</tr>
<tr>
<td></td>
<td>( netJTD = Bond\text{long} - Equity\text{short} )</td>
<td></td>
</tr>
<tr>
<td><strong>3</strong> Hedge benefit recognition</td>
<td></td>
<td>In order to recognise hedging relationship between long and short positions within a bucket, a hedge benefit ratio is computed and applied to discount the hedge benefits.</td>
</tr>
<tr>
<td></td>
<td>( WTs = \frac{\sum netJTD\text{long}}{\sum netJTD\text{long} + \sum</td>
<td>netJTD\text{short}</td>
</tr>
<tr>
<td><strong>4</strong> Bucket allocation and calculation of weighted net JTD positions and default capital charge (DRC)</td>
<td>e.g. for non-securitisation and securitisation non-correlation trading portfolio (NCTP)</td>
<td>• JTD positions are allocated to buckets and weighted. For non-securitisation risk weights are prescribed and for securitisation risk weights are to be computed applying the banking book regime.</td>
</tr>
<tr>
<td></td>
<td>( DRC_b = \max[\sum_{i\in\text{Long}} RW_i \cdot netJTD_i] - WTs (\sum_{i\in\text{Short}} RW_i</td>
<td>netJTD_i</td>
</tr>
</tbody>
</table>
The residual risk add-on is introduced to ensure that the model provides sufficient coverage of the market risks

As not all market risks can be captured with the standardised approach without necessitating an unduly complex regime, a residual risk add-on was introduced to the framework. It is to be calculated for all instruments bearing residual risk separately and in addition to any other capital requirements within the standardised approach. The scope of instruments that are subject to the residual risk add-on must not have an impact in terms of increasing or decreasing the scope of risk factors subject to the other standardised approach components.
According to Art. 325v of CRR II, instruments that are listed on a recognised exchange, that are eligible for central clearing or that perfectly offset the market risk of another position of the trading book should not be fall in the scope of the residual risk add-on.

<table>
<thead>
<tr>
<th>Calculation</th>
<th>Details</th>
</tr>
</thead>
</table>
| Residual risk add-on | - The residual risk add-on is the simple sum of gross notional amounts of the instruments bearing residual risks  
- RW = 1.0% for instruments with an exotic underlying (e.g. longevity risk, weather or natural disasters)  
- RW = 0.1% for instruments bearing other residual risks |

**Criteria for instruments bearing other residual risks**

Instruments subject to vega or curvature risk capital charges in the trading book and with pay-offs that cannot be written or perfectly replicated as a finite linear combination of vanilla options with a single underlying equity price, commodity price, exchange rate, bond price, CDS price or interest rate swap

Instruments which fall under the definition of the correlation trading portfolio (CTP), except for those instruments which are recognised in the market risk framework as eligible hedges of risks within the CTP
FRTB Impacts
**FRTB will have significant impacts on banks in terms of their operational capability, infrastructure, risk measurement, reporting and other areas**

The institutions are faced with a variety of adjustments and changes in the methodology of calculating the capital charge for market risk. Results of the quantitative impact studies published by the Basel Committee (BCBS 346) predict a **simple mean increase of 41%** and a **weighted average increase of 74%** in total **market risk capital requirements**. Still, some of this impact can be mitigated by portfolio re-optimisation.
Capital optimisation
- Asset classes and trading desks contributing mainly to the capital charge should be identified and their portfolios analysed
- This may lead to the identification of data issues increasing regulatory capital
- Adapting the asset allocation can minimise the capital charge

Regulatory reporting
- Business specifications must be in place defining the aggregation & final reporting process
- Optionality features in the portfolio require an appropriate instrument valuation methodology for the curvature risk charge
- Broadened supervisory scope will require more communication between banks and the supervisors

Portfolio review
Banks need to review their trading book to understand how the new methodology impacts the capital consumption

Desk level review
- Desk level review will likely increase the complexity of internal models, which need to be tailored to each desk
- Banks need to consider if they need to restructure their desks to reduce complexity related to models and the capital calculation

Data availability
- Banks need to develop and maintain architecture and infrastructure capability
- The data processes must be checked to provide the necessary data for correctly mapping instruments to the trading or the banking book and capital calculation
- Insufficient data on instruments may result in instruments being mapped to residual buckets, thus increasing regulatory capital.

Methodology
- Sensitivities-based methodology and expected shortfall are significant new additions
- Complexity of the methodology increases which may cause challenges especially for smaller institutions
Typically substantial regulatory changes can be challenging for institutions

Fig. 16 Overview of selected areas of regulatory change

<table>
<thead>
<tr>
<th>Special attention must be paid to several aspects of the operations and support framework</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Policy frameworks</strong>: As part of implementation of the revised standards banks need to review and revise their internal policies and related procedures (including the trading book policy, the market risk policy, the model management policy, and the model validation and backtesting policy)</td>
</tr>
<tr>
<td><strong>Infrastructure</strong>: As calculation of the standardised approach capital charge will become mandatory for benchmarking and fallback purposes, the need to build, maintain and develop risk systems – as well as data availability and quality within the banks – increases</td>
</tr>
<tr>
<td><strong>Processes, models and controls</strong>: We expect need for banks to reassess and organise their business processes and controls as a result of the new standards. The representation of risk may diverge further between business and regulatory needs. This is likely to be reflected in the processes and models needed to fulfil these needs</td>
</tr>
<tr>
<td><strong>Resources</strong>: We expect that the changes will cause a (temporary) demand for additional skilled risk personnel within the banks</td>
</tr>
</tbody>
</table>
**Banks will experience significant increase in capital charges under the revised standardised approach**

Figure 16 shows the increase in capital requirements under the revised standardised approach compared to the current standardised approach. According to the FRTB – *interim impact analysis* from November 2015, capital requirements will increase for all risk classes. FX risk class faces the most radical increase. In total, the **mean increase in capital charge is 103%** and the **median is 83%**.

**Fig. 17 Overview of the potential impact on capital requirements**

<table>
<thead>
<tr>
<th>Risk Class</th>
<th>Increase in Capital Charge</th>
<th>Mean</th>
<th>Median</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commodity risk</td>
<td>90%</td>
<td>30%</td>
<td></td>
</tr>
<tr>
<td>FX risk</td>
<td>115%</td>
<td>88%</td>
<td></td>
</tr>
<tr>
<td>Interest rate + Credit spread + Equity + Default risk</td>
<td>112%</td>
<td>37%</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>103%</td>
<td>83%</td>
<td></td>
</tr>
</tbody>
</table>

Source: FRTB – interim impact analysis (BCBS346), page 8, Table 3c, November 2015.
Note: Results are not based on the final framework.
Our Services
PwC has developed an MS-Access-based tool that complies with the final BCBS 352 and CRR II standards.

**Fig. 18 PwC SBA-Tool 2.0: Key facts**

<table>
<thead>
<tr>
<th>Implementation potential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pragmatic test calculations</td>
</tr>
<tr>
<td>Calculation of capital requirements for delta-, vega-, curvature and default risk as well as additional risk add-on for all desks</td>
</tr>
<tr>
<td>Calculations for all asset classes are possible</td>
</tr>
<tr>
<td>High adaptation flexibility for e.g. scenario analysis with different correlation parameters</td>
</tr>
</tbody>
</table>

| ✓ MS Access-based tool for calculating the Standardised Approach |
| ✓ High adaptability of the tool to client specific needs (e.g. report function and analysis function) |
| ✓ High performance regardless of portfolio size |
With the tool we are able to do the necessary calculations for the standardised approach

Fig. 19 Overview of the front-to-back calculation environment
Our Expertise
Whether regarding the Basel Committee, EU-regulation or national legislation – we use our established know-how of the analysis and implementation of new supervisory regulation to provide our clients with high-quality services. Embedded into the international PwC network, we have access to the extensive knowledge of our experts around the world.

PwC’s Basel IV Initiative was established to support you in all aspects of getting compliant with the new regulatory requirements to the trading book – accomplishing a prestudy as a first step, supporting you at quantitative impact studies (QIS) up to the implementation at all business units and areas of the bank.

PwC can draw on long lasting experience of implementing new regulatory requirements by supporting a number of banks in completing quantitative impact studies prior to the implementation of Basel II and Basel III and by the functional and technical implementation of the final regulations. The PwC-tools used during the QIS are flexible and will be updated automatically in case of new consultations by the Basel Committee.
About us
PwC helps organisations and individuals create the value they’re looking for. We’re a network of firms in 157 countries with more than 195,000 people who are committed to delivering quality in assurance, tax and advisory services. Tell us what matters to you and find out more by visiting us at www.pwc.com. Learn more about PwC by following us online: @PwC_LLP, YouTube, LinkedIn, Facebook and Google+.
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