What would be the impact of changes in market risk measurement models on banks' regulatory capital?

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Banking activity is changing and markets are increasingly volatile. This volatility creates risks that were previously measured by VaR. However, in view of the internal limits of the calculation of the VaR, the Basel Committee has decided to use a new and more comprehensive model. We will see how this new model could impact the banks' capital charge.

Why this subject?

For a long time, the VaR has been the benchmark indicator for measuring risk, but faced with the problems of increased market instability, it may no longer be effective enough.

The limitations of the VaR:

-Does not capture the external risks that banks may face

-Uses only the "delta" sensitivity, which prevents a complete risk analysis

Objectives and strategic stakes of the new FRTB standard

Redefining the boundary between the trading book and the banking book

Objective: reduce incentives to regualtory arbitrage

Standard model review

Consideration of extreme risks through the use of ES rather than VaR in order to maintain sufficient capital in times of market tension

Internal model review

More consistent approach of the identification and capital coverage of significant risks

Integration of market illiquidity risk

Objective: mitigate the risk of a sudden and severe deterioration in market liquidity in all asset markets.

How is the proportion of capital (equity) reserved for market risk measured?

Standard Model

Calculation of required capital = Charge for risk sensitivity + Charge for default + Charge for residual risk

Internal Model

-Estimation of ES at the 97,5% threshold

-Variable time horizon of up to 120 days

Impact of FRTB on banks

Median (weighted average) increase of approximately 22% (40%) in total capital required for market risk

Decrease in certain risks weights (e.g. foreign exchange risk -50%)

Emergence of new challenges in terms of data management and data quality

Conclusion and recommendations

The new FRTB standard enables better management of market risks and closes VaR gaps by providing a better estimate of market risk and the associated capital charge. The capital charge is increasing as a result of improved measurement methods. To cope with this increase, banks should develop new investment strategies, while taking into account the cost that these strategies will generate.