Finance Watch
Making finance serve society

Finance Watch response to EU Commission Targeted consultation on the application of the market risk prudential framework

Brussels, 22 April 2025

The Fundamental Review of the Trading Book (FRTB) has been crafted to address the inherent limitations of the current market risk internal models, notably the Value-at-Risk (VaR) and Stressed Value-at-Risk (SVaR) approaches. These models fail to adequately capture tail risks and liquidity risks, leading to an underestimation of market risk in times of stressed market conditions for institutions using Internal Models Approach (IMA).

Given the escalating geopolitical tensions in the world, we are likely to experience more stressed market conditions going forward. The EU Commission's role is crucial in ensuring the sustainability of the EU financial system. As we navigate potentially volatile times, a robust market risk framework is indispensable. While the FRTB may appear more conservative in certain aspects, it is essential to safeguard society from another financial crisis. Considering the essential investment needs of the EU related to its climate objectives, innovation, and defence, ensuring the stability of the financial system and its ability to keep financing the economy should be a political priority, rather than running a risk of another taxpayer-sponsored bailout of private banks due to their risk underestimation. The decision by other jurisdictions to delay the FRTB implementation, thereby risking financial instability, is a gamble that the EU should not take. Moreover, the foreseen implementation of FRTB has already provided banks with the lead time to enhance their risk management frameworks, including transparency, data pipelines, automation, simplification and consistency between front office and risk modelling. Embracing the FRTB should be viewed as an opportunity for improvement, not merely a cost.

<u>Question 1:</u> No further delay

Any further delay in implementing the FRTB will perpetuate the existing weaknesses in financial institutions' market risk frameworks. As we enter a period of high volatility due to geopolitical tensions, completing the work to overcome the limitations of the existing market risk framework is imperative. Delaying FRTB implementation would leave our financial system vulnerable at a time when robust risk management is crucial.

The arguments for delaying the FRTB implementation advanced by the Commission in the consultation document - such as preserving the level playing field and avoiding significant

+32 (0)2 880 0430
contact@finance-watch.org
Rue des Colonies 56, box 3
1000 Brussels
Reg / VAT
BE0836.636.381

competitive disadvantages for EU banks - do not stand up to scrutiny, as they appear to be politically rather than empirically motivated. A competitive banking system is one able to withstand market stress and maintain steady financing of the economy. BCBS studies found that banks with more robust capital ratios were more reliable lenders, better able to increase their lending, and less likely to damage communities by going bust.

Further, the BCBS studies[1] have also shown that in the past, banks were moving to higher capital levels mainly by retaining profits, not by cutting lending. It should also be noted that for the EU banks, market risk charge represents a relatively small increase of the minimum required capital related to the Basel III implementation (the major drivers being output floor and operational risk), as shown by the EBA Basel III Monitoring reports[2].

<u>Question 3:</u> Commission amendment proposals

1) Profit and Loss Attribution Test (PLAT) as a monitoring tool

The Profit and Loss Attribution (PLAT) ensures consistency between the P&L used and computed in risk modelling and front office units. This consistency is a prerequisite for relying on internal risk models. Therefore, the PLAT requirements should not be postponed, as it is foundational to the integrity of the risk management framework.

2) Phase-in of the capital requirements for Non-Modellable Risk Factors (NMRF):

Underlying assets that lack up-to-date and sufficient historical market data cannot fulfil the Risk Factor Eligibility Test (RFET) requirements and fall under Non-modellable risk factors (NMRF). The European Commission proposes to reduce the NMRF capital requirement charge by applying a flat factor over a three-year period. This raises the question of whether a possible underestimation of risks associated with certain underlying assets should be an acceptable temporary solution from the prudential perspective. In the current geopolitical climate, the prudent approach is to reject such underestimation.

[1] BCBS, "How have banks adjusted to higher capital requirements?"
[2] EBA, impact of the Basel III reforms on EU banks' capital

Finance Watch
Making finance serve society

3) Proportional data requirements for the risk factor eligibility test (RFET) of new instruments:

By definition, new issues lack historical data and cannot meet the RFET requirements. In the case of a prorata solution in applying the RFET, this means that a proxy will be used to compute the expected shortfall, which might lead to risk underestimation. This raises the same concern as expressed for Amendment 2, and the answer should also be the same.