EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB staff contribution to the European Commission's targeted consultation on the application of the market risk prudential framework

The European Central Bank (ECB) welcomes the European Commission's targeted consultation on the application of the market risk prudential framework. Market risk is a significant risk for banks and was one of the main causes of the global financial crisis. Geopolitical risks, including trade tensions and ongoing military conflicts are having an impact on financial markets. We know from experience that adverse developments in financial markets can materialise very suddenly and with a highly amplified impact, for example through fire-sales and contagion effects. It is therefore particularly important to remain vigilant towards market risk in the current environment. In introducing a more risk-based approach, the Fundamental Review of the Trading Book (FRTB) framework not only captures risks more effectively in capital requirements but also provides a good basis for sound risk management practice.

The ECB shares the view that maintaining a global level-playing field in the application of internationally agreed standards is important. In this respect, the co-legislators provided the Commission with the flexibility to amend the rules on FRTB via the empowerment in Article 461a of the Capital Requirements Regulation (CRR). The targeted consultation puts forward several potential policy options. Assuming that the option of using the empowerment in Article 461a CRR is pursued, the ECB wishes to share the following observations.

Postponing the start date for the application of the full new market risk framework for a further year (i.e. to 1 January 2027), or substantially amending the framework, would not be necessary from a prudential viewpoint. While a delay has the potential to offer a simple solution, ECB staff considers it does not remove uncertainty on how FRTB will finally be implemented. Supervisors and banks have already done considerable work on FRTB implementation ahead of the framework's planned entry into force in 2026. A delay would unfairly penalise banks that have duly prepared and are ready to move to a more risk-sensitive approach. Banks will need to continue running both the old and new systems in parallel, which will come at a cost. Moreover, current internal market risk models are less maintained and supervised because of the upcoming new regulation, resulting in increased risk the longer these models are kept in use.

A combination of options (e.g. delaying the internal models approach and introducing the standardised approach with targeted adjustments) could help keep the momentum on FRTB implementation. In such a scenario, the FRTB standardised approach (FRTB-SA) would become a formal supervisory requirement, and the market would have clarity regarding the entry into force of the internal model approach (FRTB-IMA) after the additional one-year extension[1].

However, additional specifications would be needed in order to address implementation issues stemming from combining options in this way. For example, banks opting for the standardised approach could face different boundary requirements for trading book vs. banking book exposures compared with banks opting to remain under the current internal models approach. To maintain a level playing field it would be important that all institutions operate under the same boundary requirements. Moreover, banks should avoid keeping less maintained internal model approaches for the sole purpose of reducing capital requirements.

Any temporary and targeted amendments to the alternative standardised approach should be duly justified, temporary and risk-based, and should uphold the same level of resilience in the banking sector. In this regard, the ECB wishes to share the following remarks on how to avoid undue repercussions for the quality of risk management.

To cater for the uncertainty regarding the implementation of the Basel standards in other jurisdictions, an ascending scalar over a three-year period could be preferable to the proposal to apply a flat 0.9 multiplier to own funds requirements under the FRTB-SA. The ECB would like to note that reporting requirements for the alternative standardised approach for market risk have been in force for several years. Based on reported numbers, the capital impact of the entry into force of the requirements can be estimated. This impact appears to be manageable: for the vast majority of significant institutions the impact is either close to zero or a net benefit. Some banks show a CET1 impact of over 25 bps – if we were to assume that all banks would apply the FRTB SA without amendments. Furthermore, the impact of FRTB implementation constitutes only a small part of the overall CRR3 impact. An ascending multiplier would therefore be manageable from an own funds perspective. It would also avoid the complexity inherent in more granular adjustments and provide clarity around the path to implementation[2].

With regard to internal model-related requirements, the proposals for temporary flexibility in applying the profit and loss attribution test as well as for phasing-in requirements for non-modellable risk factors would in our view need to be accompanied by appropriate supervisory safeguards if introduced. For the profit and loss attribution test, the supervisor should have the means to intervene to react to concerning outcomes. For non-modellable risk factors, the phase-in could follow an ascending scalar logic, as proposed in the previous paragraph. In our view the adaptations for recently issued instruments may ultimately not be necessary, but if introduced they should at a minimum be framed in a risk-based manner.

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[1] Article 461a(2)b empowers the Commission to postpone the entry into force of own funds requirements for market risk for a maximum of two years.

[2] Such a scalar could be calibrated based on the estimated impact of introducing FRTB-SA at a given time and be applied to the respective capital requirements of banks. The effect of the scalar would be reduced over time, so that by the end of the transition period, banks would need to take into account the full impact of FRTB-SA framework.

Regarding the proposals for amending the requirements related to capitalising collective investment undertaking (CIU) exposures under the alternative standardised approach, one particular aspect may be too far-reaching. The ECB would have strong concerns about allowing banks to carry out the look-through on a quarterly basis for material exposures. A quarterly look-through would not be sufficient to adequately capture the underlying risks of CIU exposures, nor would it be in line with general expectations on sound risk management. It could also give rise to quarterly window dressing for prudential capital requirements. Furthermore, as a supervisor the ECB expects banks to have in place sound risk data aggregation and data infrastructure capabilities[3], including for market risk, which should allow a more frequent look through (in addition, technological progress makes such capabilities far less expensive).

Last, whilst the purpose of the Delegated Act is to respond to developments affecting the regulatory level playing field, questions related to market risk supervision could also be taken into consideration. The issue of simplifying supervisory processes in a way that fosters risk-based supervision deserves consideration. For the FRTB implementation phase, it will be important for supervisors to exercise judgement and focus on key risks. ECB staff would support temporary simplification measures that support this objective.

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3 As laid out in the ECB Guide on effective risk data aggregation and risk reporting.