Guidelines for computing capital for incremental risk in the trading book - final version

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The Basel Committee/IOSCO Agreement reached in July 2005, [1] contained several improvements to the capital regime for trading book positions. Among these revisions was a new requirement for banks that model specific risk to measure and hold capital against default risk that is incremental to any default risk captured in the bank's value-at-risk (VaR) model. The incremental default risk charge was incorporated into the trading book capital regime in response to the increasing amount of exposure in banks' trading books to credit risk related and often illiquid products whose risk is not reflected in VaR. In October 2007, the Basel Committee on Banking Supervision (the Committee) released guidelines for computing capital for incremental default risk for public comments. At its meeting in March 2008, it reviewed comments received and decided to expand the scope of the capital charge. The decision was taken in light of the recent credit market turmoil where a number of major banking organisations have experienced large losses, most of which were sustained in banks' trading books. Most of those losses were not captured in the 99%/10-day VaR. Since the losses have not arisen from actual defaults but rather from credit migrations combined with widening of credit spreads and the loss of liquidity, applying an incremental risk charge covering default risk only would not appear adequate. For example, a number of global financial institutions commented that singling out just default risk was inconsistent with their internal practices and could be potentially burdensome.

The incremental risk charge (IRC) is intended to complement additional standards being applied to the value-at-risk modelling framework. Together, these changes address a number of perceived shortcomings in the current 99%/10-day VaR framework. Foremost, the current VaR framework ignores differences in the underlying liquidity of trading book positions. In addition, these VaR calculations are typically based on a 99%/one-day VaR which is scaled up to 10 days. Consequently, the VaR capital charge may not fully reflect large daily losses that occur less frequently than two to three times per year as well as the potential for large cumulative price movements over periods of several weeks or months. Moreover, the current framework's emphasis on modelling short-run P&L volatility (eg backtesting requirements) allows the use of relatively short data windows for estimating VaR parameters (as short as one year), which can produce insufficient required capital against trading positions following periods of relative calm in financial markets.

The IRC represents an estimate of the default and migration risks of unsecuritised credit products over a one-year capital horizon at a 99.9 percent confidence level, taking into account the liquidity horizons of individual positions or sets of positions. The Committee expects banks to develop their own models for calculating the IRC for these positions. This paper provides guidelines on how an IRC model should be developed. It also contains guidance on how supervisors should evaluate banks' IRC models.

As there is no single industry standard for addressing the trading book issues noted above, the IRC guidelines generally take the form of high level principles, with considerable flexibility afforded banks in terms of how to operationalise these principles. The Committee, through its Trading Book Group, will continue to work closely with industry groups and individual firms during the implementation period of the new capital requirement.

Banks have to meet the guidelines for calculating the IRC that are laid out in this document to the extent that they seek to model incremental risks according to paragraph 718(xcii) or comprehensive risks according to paragraph 718(xcv) of the Basel II framework as outlined in the Revisions to the Basel II market risk framework [2].

The Committee has already conducted a preliminary analysis of the impact of an incremental risk capital charge only including default and migration risk, largely relying on the data collected from its quantitative impact study on incremental default risk in late 2007. It has collected additional data in 2009 to assess the impact of changes to the trading book capital framework. In the coming months, the Committee will review the calibration of the market risk framework in light of the results of this impact assessment. This review will also include the floor to the liquidity horizon specified in paragraph 20.

The remainder of this paper is structured as follows:

- Section II sets forth the scope of the IRC and principles underlying the construction of IRC models.
- Section III discusses the validation of IRC models.
- Section IV specifies ways in which the results of banks' internal risk measurement models can be used as the foundation for an IRC.

A consultative version of this paper was released in January 2009.

Full document: http://www.bis.org/publ/bcbs159.htm

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[1] Basel Committee on Banking Supervision, *The application of Basel II to trading activities and the treatment of double default effects*, July 2005.
[2] Basel Committee on Banking Supervision, *Revisions to the Basel II market risk framework*, July 2009.