

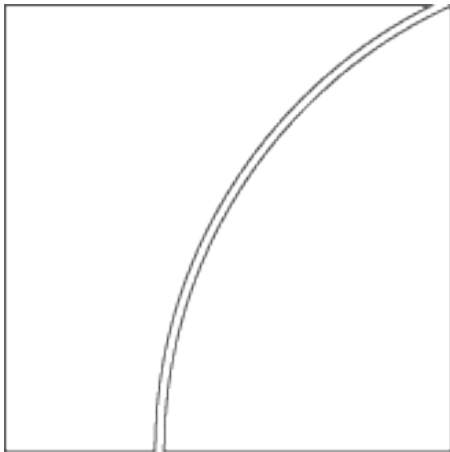
Basel Committee on Banking Supervision

RBC

Risk-based capital
requirements

RBC25

Boundary between the
banking book and the trading
book



**Version effective as of
01 Jan 2023**

Updated to take account of the January 2019
market risk publication and the revised
implementation date announced on 27 March
2020.



BANK FOR INTERNATIONAL SETTLEMENTS

Scope of the trading book

- 25.1** A trading book consists of all instruments that meet the specifications for trading book instruments set out in [RBC25.2](#) through [RBC25.13](#). All other instruments must be included in the banking book.
- 25.2** Instruments comprise financial instruments, foreign exchange (FX), and commodities. A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. Financial instruments include both primary financial instruments (or cash instruments) and derivative financial instruments. A financial asset is any asset that is cash, the right to receive cash or another financial asset or a commodity, or an equity instrument. A financial liability is the contractual obligation to deliver cash or another financial asset or a commodity. Commodities also include non-tangible (ie non-physical) goods such as electric power.
- 25.3** Banks may only include a financial instrument, instruments on FX or commodity in the trading book when there is no legal impediment against selling or fully hedging it.
- 25.4** Banks must fair value daily any trading book instrument and recognise any valuation change in the profit and loss (P&L) account.

Standards for assigning instruments to the regulatory books

- 25.5** Any instrument a bank holds for one or more of the following purposes must, when it is first recognised on its books, be designated as a trading book instrument, unless specifically otherwise provided for in [RBC25.3](#) or [RBC25.8](#):
- (1) short-term resale;
 - (2) profiting from short-term price movements;
 - (3) locking in arbitrage profits; or
 - (4) hedging risks that arise from instruments meeting (1), (2) or (3) above.
- 25.6** Any of the following instruments is seen as being held for at least one of the purposes listed in [RBC25.5](#) and must therefore be included in the trading book, unless specifically otherwise provided for in [RBC25.3](#) or [RBC25.8](#):
- (1) instruments in the correlation trading portfolio;

- (2) instruments that would give rise to a net short credit or equity position in the banking book;¹ or
- (3) instruments resulting from underwriting commitments, where underwriting commitments refer only to securities underwriting, and relate only to securities that are expected to be actually purchased by the bank on the settlement date.

Footnotes

¹ *A bank will have a net short risk position for equity risk or credit risk in the banking book if the present value of the banking book increases when an equity price decreases or when a credit spread on an issuer or group of issuers of debt increases.*

25.7 Any instrument which is not held for any of the purposes listed in [RBC25.5](#) at inception, nor seen as being held for these purposes according to [RBC25.6](#), must be assigned to the banking book.

25.8 The following instruments must be assigned to the banking book:

- (1) unlisted equities;
- (2) instruments designated for securitisation warehousing;
- (3) real estate holdings, where in the context of assigning instrument to the trading book, real estate holdings relate only to direct holdings of real estate as well as derivatives on direct holdings;
- (4) retail and small or medium-sized enterprise (SME) credit;
- (5) equity investments in a fund, unless the bank meets at least one of the following conditions:
 - (a) the bank is able to look through the fund to its individual components and there is sufficient and frequent information, verified by an independent third party, provided to the bank regarding the fund's composition; or
 - (b) the bank obtains daily price quotes for the fund and it has access to the information contained in the fund's mandate or in the national regulations governing such investment funds;

- (6) hedge funds;
- (7) derivative instruments and funds that have the above instrument types as underlying assets; or
- (8) instruments held for the purpose of hedging a particular risk of a position in the types of instrument above.

25.9 There is a general presumption that any of the following instruments are being held for at least one of the purposes listed in [RBC25.5](#) and therefore are trading book instruments, unless specifically otherwise provided for in [RBC25.3](#) or [RBC25.8](#):

- (1) instruments held as accounting trading assets or liabilities;²
- (2) instruments resulting from market-making activities;
- (3) equity investments in a fund excluding those assigned to the banking book in accordance with [RBC25.8\(5\)](#);
- (4) listed equities;³
- (5) trading-related repo-style transaction;⁴ or
- (6) options including embedded derivatives⁵ from instruments that the institution issued out of its own banking book and that relate to credit or equity risk.

Footnotes

- ² Under IFRS (IAS 39) and US GAAP, these instruments would be designated as held for trading. Under IFRS 9, these instruments would be held within a trading business model. These instruments would be fair valued through the P&L account.
- ³ Subject to supervisory review, certain listed equities may be excluded from the market risk framework. Examples of equities that may be excluded include, but are not limited to, equity positions arising from deferred compensation plans, convertible debt securities, loan products with interest paid in the form of "equity kickers", equities taken as a debt previously contracted, bank-owned life insurance products, and legislated programmes. The set of listed equities that the bank wishes to exclude from the market risk framework should be made available to, and discussed with, the national supervisor and should be managed by a desk that is separate from desks for proprietary or short-term buy/sell instruments.
- ⁴ Repo-style transactions that are (i) entered for liquidity management and (ii) valued at accrual for accounting purposes are not part of the presumptive list of [RBC25.9](#).
- ⁵ An embedded derivative is a component of a hybrid contract that includes a non-derivative host such as liabilities issued out of the bank's own banking book that contain embedded derivatives. The embedded derivative associated with the issued instrument (ie host) should be bifurcated and separately recognised on the bank's balance sheet for accounting purposes.

25.10 Banks are allowed to deviate from the presumptive list specified in [RBC25.9](#) according to the process set out below.⁶

- (1) If a bank believes that it needs to deviate from the presumptive list established in [RBC25.9](#) for an instrument, it must submit a request to its supervisor and receive explicit approval. In its request, the bank must provide evidence that the instrument is not held for any of the purposes in [RBC25.5](#).
- (2) In cases where this approval is not given by the supervisor, the instrument must be designated as a trading book instrument. Banks must document any deviations from the presumptive list in detail on an on-going basis.

Footnotes

- 6 *The presumptions for the designation of an instrument to the trading book or banking book set out in this text will be used where a designation of an instrument to the trading book or banking book is not otherwise specified in this text.*

Supervisory powers

- 25.11** Notwithstanding the process established in [RBC25.10](#) for instruments on the presumptive list, the supervisor may require the bank to provide evidence that an instrument in the trading book is held for at least one of the purposes of [RBC25.5](#). If the supervisor is of the view that a bank has not provided enough evidence or if the supervisor believes the instrument customarily would belong in the banking book, it may require the bank to assign the instrument to the banking book, except if it is an instrument listed under [RBC25.6](#).
- 25.12** The supervisor may require the bank to provide evidence that an instrument in the banking book is not held for any of the purposes of [RBC25.5](#). If the supervisor is of the view that a bank has not provided enough evidence, or if the supervisor believes such instruments would customarily belong in the trading book, it may require the bank to assign the instrument to the trading book, except if it is an instrument listed under [RBC25.8](#).

Documentation of instrument designation

- 25.13** A bank must have clearly defined policies, procedures and documented practices for determining which instruments to include in or to exclude from the trading book for the purposes of calculating their regulatory capital, ensuring compliance with the criteria set forth in this section, and taking into account the bank's risk management capabilities and practices. A bank's internal control functions must conduct an ongoing evaluation of instruments both in and out of the trading book to assess whether its instruments are being properly designated initially as trading or non-trading instruments in the context of the bank's trading activities. Compliance with the policies and procedures must be fully documented and subject to periodic (at least yearly) internal audit and the results must be available for supervisory review.

Restrictions on moving instruments between the regulatory books

- 25.14** Apart from moves required by [RBC25.5](#) through [RBC25.10](#), there is a strict limit on the ability of banks to move instruments between the trading book and the banking book by their own discretion after initial designation, which is subject to the process in [RBC25.15](#) and [RBC25.16](#). Switching instruments for regulatory arbitrage is strictly prohibited. In practice, switching should be rare and will be allowed by supervisors only in extraordinary circumstances. Examples are a major publicly announced event, such as a bank restructuring that results in the permanent closure of trading desks, requiring termination of the business activity applicable to the instrument or portfolio or a change in accounting standards that allows an item to be fair-valued through P&L. Market events, changes in the liquidity of a financial instrument, or a change of trading intent alone are not valid reasons for reassigning an instrument to a different book. When switching positions, banks must ensure that the standards described in [RBC25.5](#) to [RBC25.10](#) are always strictly observed.
- 25.15** Without exception, a capital benefit as a result of switching will not be allowed in any case or circumstance. This means that the bank must determine its total capital requirement (across the banking book and trading book) before and immediately after the switch. If this capital requirement is reduced as a result of this switch, the difference as measured at the time of the switch will be imposed on the bank as a disclosed Pillar 1 capital surcharge. This surcharge will be allowed to run off as the positions mature or expire, in a manner agreed with the supervisor. To maintain operational simplicity, it is not envisaged that this additional capital requirement would be recalculated on an ongoing basis, although the positions would continue to also be subject to the ongoing capital requirements of the book into which they have been switched.
- 25.16** Any reassignment between books must be approved by senior management and the supervisor as follows. Any reallocation of securities between the trading book and banking book, including outright sales at arm's length, should be considered a reassignment of securities and is governed by requirements of this paragraph.
- (1) Any reassignment must be approved by senior management thoroughly documented; determined by internal review to be in compliance with the bank's policies; subject to prior approval by the supervisor based on supporting documentation provided by the bank; and publicly disclosed.
 - (2) Unless required by changes in the characteristics of a position, any such reassignment is irrevocable.

- (3) If an instrument is reclassified to be an accounting trading asset or liability there is a presumption that this instrument is in the trading book, as described in [RBC25.9](#). Accordingly, in this case an automatic switch without approval of the supervisor is acceptable.

25.17 A bank must adopt relevant policies that must be updated at least yearly. Updates should be based on an analysis of all extraordinary events identified during the previous year. Updated policies with changes highlighted must be sent to the appropriate supervisor. Policies must include the following:

- (1) The reassignment restriction requirements in [RBC25.14](#) through [RBC25.16](#), especially the restriction that re-designation between the trading book and banking book may only be allowed in extraordinary circumstances, and a description of the circumstances or criteria where such a switch may be considered.
- (2) The process for obtaining senior management and supervisory approval for such a transfer.
- (3) How a bank identifies an extraordinary event.
- (4) A requirement that re-assignments into or out of the trading book be publicly disclosed at the earliest reporting date.

Treatment of internal risk transfers

25.18 An internal risk transfer is an internal written record of a transfer of risk within the banking book, between the banking and the trading book or within the trading book (between different desks).

25.19 There will be no regulatory capital recognition for internal risk transfers from the trading book to the banking book. Thus, if a bank engages in an internal risk transfer from the trading book to the banking book (eg for economic reasons) this internal risk transfer would not be taken into account when the regulatory capital requirements are determined.

25.20 For internal risk transfers from the banking book to the trading book, [RBC25.21](#) to [RBC25.27](#) apply.

Internal risk transfer of credit and equity risk from banking book to trading book

25.21

When a bank hedges a banking book credit risk exposure or equity risk exposure using a hedging instrument purchased through its trading book (ie using an internal risk transfer),

- (1) The credit exposure in the banking book is deemed to be hedged for capital requirement purposes if and only if:
 - (a) the trading book enters into an external hedge with an eligible third-party protection provider that exactly matches the internal risk transfer; and
 - (b) the external hedge meets the requirements of [CRE22.74](#) to [CRE22.75](#) and [CRE22.77](#) to [CRE22.78](#) vis-à-vis the banking book exposure.⁷
- (2) The equity exposure in the banking book is deemed to be hedged for capital requirement purposes if and only if:
 - (a) the trading book enters into an external hedge from an eligible third-party protection provider that exactly matches the internal risk transfer; and
 - (b) the external hedge is recognised as a hedge of a banking book equity exposure.
- (3) External hedges for the purposes of [RBC25.21](#)(1) can be made up of multiple transactions with multiple counterparties as long as the aggregate external hedge exactly matches the internal risk transfer, and the internal risk transfer exactly matches the aggregate external hedge.

Footnotes

⁷ *With respect to [CRE22.75](#), the cap of 60% on a credit derivative without a restructuring obligation only applies with regard to recognition of credit risk mitigation of the banking book instrument for regulatory capital purposes and not with regard to the amount of the internal risk transfer.*

25.22 Where the requirements in [RBC25.21](#) are fulfilled, the banking book exposure is deemed to be hedged by the banking book leg of the internal risk transfer for capital purposes in the banking book. Moreover both the trading book leg of the internal risk transfer and the external hedge must be included in the market risk capital requirements.

25.23

Where the requirements in [RBC25.21](#) are not fulfilled, the banking book exposure is not deemed to be hedged by the banking book leg of the internal risk transfer for capital purposes in the banking book. Moreover, the third-party external hedge must be fully included in the market risk capital requirements and the trading book leg of the internal risk transfer must be fully excluded from the market risk capital requirements.

25.24 A banking book short credit position or a banking book short equity position created by an internal risk transfer⁸ and not capitalised under banking book rules must be capitalised under the market risk rules together with the trading book exposure.

Footnotes

⁸ *Banking book instruments that are over-hedged by their respective documented internal risk transfer create a short (risk) position in the banking book.*

Internal risk transfer of general interest rate risk from banking book to trading book

25.25 When a bank hedges a banking book interest rate risk exposure using an internal risk transfer with its trading book, the trading book leg of the internal risk transfer is treated as a trading book instrument under the market risk framework if and only if:

- (1) the internal risk transfer is documented with respect to the banking book interest rate risk being hedged and the sources of such risk;
- (2) the internal risk transfer is conducted with a dedicated internal risk transfer trading desk which has been specifically approved by the supervisor for this purpose; and
- (3) the internal risk transfer must be subject to trading book capital requirements under the market risk framework on a stand-alone basis for the dedicated internal risk transfer desk, separate from any other GIRR or other market risks generated by activities in the trading book.

25.26 Where the requirements in [RBC25.25](#) are fulfilled, the banking book leg of the internal risk transfer must be included in the banking book's measure of interest rate risk exposures for regulatory capital purposes.

25.27 The supervisor-approved internal risk transfer desk may include instruments purchased from the market (ie external parties to the bank). Such transactions may be executed directly between the internal risk transfer desk and the market. Alternatively, the internal risk transfer desk may obtain the external hedge from the market via a separate non-internal risk transfer trading desk acting as an agent, if and only if the GIRR internal risk transfer entered into with the non-internal risk transfer trading desk exactly matches the external hedge from the market. In this latter case the respective legs of the GIRR internal risk transfer are included in the internal risk transfer desk and the non-internal risk transfer desk.

Internal risk transfers within the scope of application of the market risk capital requirement

25.28 Internal risk transfers between trading desks within the scope of application of the market risk capital requirements (including FX risk and commodities risk in the banking book) will generally receive regulatory capital recognition. Internal risk transfers between the internal risk transfer desk and other trading desks will only receive regulatory capital recognition if the constraints in [RBC25.25](#) to [RBC25.27](#) are fulfilled.

25.29 The trading book leg of internal risk transfers must fulfil the same requirements under [RBC25](#) as instruments in the trading book transacted with external counterparties.

Eligible hedges for the CVA capital requirement

25.30 Eligible external hedges that are included in the credit valuation adjustment (CVA) capital requirement must be removed from the bank's market risk capital requirement calculation.

25.31 Banks may enter into internal risk transfers between the CVA portfolio and the trading book. Such an internal risk transfer consists of a CVA portfolio side and a non-CVA portfolio side. Where the CVA portfolio side of an internal risk transfer is recognised in the CVA risk capital requirement, the CVA portfolio side should be excluded from the market risk capital requirement, while the non-CVA portfolio side should be included in the market risk capital requirement.

25.32 In any case, such internal CVA risk transfers can only receive regulatory capital recognition if the internal risk transfer is documented with respect to the CVA risk being hedged and the sources of such risk.

25.33 Internal CVA risk transfers that are subject to curvature, default risk or residual risk add-on as set out in [MAR20](#) through [MAR23](#) may be recognised in the CVA

portfolio capital requirement and market risk capital requirement only if the trading book additionally enters into an external hedge with an eligible third-party protection provider that exactly matches the internal risk transfer.

25.34 Independent from the treatment in the CVA risk capital requirement and the market risk capital requirement, internal risk transfers between the CVA portfolio and the trading book can be used to hedge the counterparty credit risk exposure of a derivative instrument in the trading or banking book as long as the requirements of [RBC25.21](#) are met.