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# Trading book and credit risk: How fundamental is the Basel review?<sup>☆,☆☆,☆☆☆</sup>

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## Abstract

Within the new Basel regulatory framework for market risks, non-securitization credit positions in the trading book are subject to a separate default risk charge (formally incremental default risk charge). Banks using the internal model approach are required to use a two-factor model and a 99.9% VaR capital charge. This model prescription is intended to reduce risk-weighted asset variability, a known feature of internal models, and improve their comparability among financial institutions. In this article, we analyze the theoretical foundations and relevance of these proposals. We investigate the practical implications of the two-factor and correlation calibration constraints through numerical applications. We introduce the Hoeffding decomposition of the aggregate unconditional loss to provide a systematic-idiosyncratic representation. In particular, we examine the impacts of a  $J$ -factor correlation structure on risk measures and risk factor contributions for long-only and long-short credit-sensitive portfolios.

*Keywords:* Fundamental review of the trading book, Portfolio credit risk modeling, Factor models, Risk contribution.

*JEL classification:* G18, C51.

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