

Expert Talk

Regulators reassessing the FRTB Internal Models Approach

How US and EU reforms shape market risk
capital and data strategies



Introduction

Major regulators are reassessing the Fundamental Review of the Trading Book (FRTB) framework, with renewed focus on the viability of the Internal Models Approach (IMA). Recent developments in both the United States and the European Union point to a shared objective: reducing unnecessary complexity, addressing capital impacts and reducing the complexity for Internal Models implementation.

In March 2026, the US Federal Reserve published a revised proposal as part of its Basel III Endgame package, introducing substantive changes to the IMA framework. Earlier, in November 2025, the European Commission launched a consultation exploring targeted relief measures within the fixed CRR III implementation timeline. While both initiatives seek to lower operational barriers to IMA adoption, they take notably different approaches, particularly in the treatment of Non-Modellable Risk Factors (NMRFs).

Against this evolving regulatory backdrop, LSEG continues to support market participants as they navigate FRTB implementation with confidence, transparency and high-quality data.

What this expert talk will explore:

- How global regulators are introducing targeted adjustments to widen the practical use of the FRTB Internal Models Approach.
- The US Federal Reserve's March 2026 proposal and its structural simplification of IMA requirements, including Profit and Loss Attribution (PLA) and NMRF treatment.
- The European Commission's November 2025 consultation and proposed temporary relief within the CRR III framework.
- Key areas of divergence between the US and EU approaches, particularly around NMRF classification and capital impact.
- Why data observability remains central to IMA eligibility and market risk capital outcomes across jurisdictions.

Internal models under FRTB: Adoption challenges and capital impact

Under the Basel FRTB framework, banks may calculate market risk capital using their own internal models, subject to a demanding set of quantitative and qualitative eligibility criteria. Central requirements include:

- Profit and Loss Attribution (PLA), which assesses alignment between front-office and risk theoretical P&L.
- Risk Factor Eligibility Test (RFET), which determines whether risk factors are sufficiently observable to be included in the Expected Shortfall (ES) methodology for capital requirements calculation.
- Non-Modellable Risk Factors (NMRFs), which are excluded from ES and instead attract a more punitive Stressed Expected Shortfall (SES) capital charge.

Experience from early implementations and proof-of-concept exercises suggests that these requirements are costly and resource-intensive to operationalise. They introduce significant model risk and operational complexity, while often delivering limited capital efficiency benefits. Survey data published by ISDA indicated that, under the original FRTB specifications, only around ten global banks expected to retain IMA approval, compared with more than 80 institutions under the current pre-FRTB market risk regime.

The US federal reserve's Basel III endgame proposal

On 19 March 2026, the US Federal Reserve published a revised Basel III proposal that includes material changes to market risk capital and the FRTB Internal Models Approach. The consultation period runs until June 2026. The proposal departs from the Basel framework in several respects, with a stated aim of simplifying IMA implementation while preserving risk sensitivity.

Profit and loss attribution: Easing the transition

Key changes to the PLA framework include:

- A three-year transition period during which PLA test failures carry no automatic regulatory consequences, allowing banks to build model capability without immediate capital penalties.
- Removal of the Spearman rank correlation metric, leaving the Kolmogorov–Smirnov test as the sole PLA measure and rendering it non-binding during the transition phase.

Rethinking the NMRF framework

The proposal introduces a materially revised approach to NMRFs, including:

- Two distinct RFET assessments: a qualitative test and a quantitative test.
- The qualitative RFET is focused on whether IMCC Expected Shortfall model inputs adequately capture the underlying risk factor.
- The quantitative RFET has been recalibrated with:
 - A minimum of 24 observations per year for liquid risk factors (liquidity horizons of 20 days or less).
 - A minimum of 16 observations for other risk factors.
 - Removal of the 100-observations requirement and the 90-day backstop period.

Risk factors are then classified into three categories:

- Modellable risk factors, subject to the Internally Modelled Capital Calculation (IMCC).
- NMRF Type A, which pass qualitative but not quantitative tests and contribute to both IMCC and SES.
- NMRF Type B, which are subject to SES only.

This structure allows certain previously non-modellable risk factors to contribute to Expected Shortfall, reducing the overall NMRF capital surcharge compared with the Basel and EU frameworks.

The European commission's CRR III consultation

In November 2025, the European Commission issued a consultation under Article 461 of CRR III, reflecting concerns around international divergence in FRTB implementation. This followed decisions by other jurisdictions, including the UK's deferral of IMA implementation to 2028 and continued uncertainty around the US timeline.

While the CRR III go-live date of January 2027 remains fixed, the Commission may introduce temporary relief measures and capital multipliers for up to three years.

The consultation focuses on two areas:

1. Targeted amendments to market risk provisions where other jurisdictions have deviated from Basel standards.
2. Temporary capital multipliers to cap increases in aggregate market risk capital.

Proposed IMA relief measures

Key proposals relevant to Internal Models include:

- Retaining PLA as a supervisory monitoring tool for a temporary period.
- Introducing a flat, transitional NMRF capital multiplier in the range of 35–45%.
- Providing operational relief for newly issued instruments, including:
 - Allowing the RFET observability period to begin when an instrument first trades.
 - Pro-rating observation requirements during the first year following issuance.

These measures reduce near-term operational burden and capital impact, while leaving the underlying Basel NMRF structure largely intact.

NMRFs as a point of regulatory divergence

A key distinction between the US and EU approaches lies in their treatment of Non-Modellable Risk Factors. The EU approach retains the Basel RFET framework and relies on temporary capital multipliers to smooth outcomes. NMRFs remain fully excluded from Expected Shortfall and subject to SES, with relief delivered through transitional measures rather than structural change. The US approach, by contrast, introduces a fundamentally revised NMRF framework. By allowing certain NMRFs to contribute to Expected Shortfall and by recalibrating eligibility thresholds, it redistributes capital impacts across risk factors rather than deferring them through multipliers.

Data observability and the persistent NMRF challenge

Proofs of concept conducted by banks operating under the Internal Models Approach consistently show that NMRFs are a major driver of FRTB market risk capital requirements. The root cause is the difficulty of sourcing a sufficient volume of real price observations (RPOs) to demonstrate modellability.

Structural factors compound this challenge. Large portions of trading portfolios consist of over-the-counter instruments in relatively illiquid markets, such as certain interest rate, equity and long-dated FX options. Internal trading activity alone is often insufficient to meet RFET thresholds, while third-party NMRF data solutions remain limited. These solutions require sustained investment, must be subject to annual regulatory audits to be compliant with the regulation, and face uncertainty as the number of banks pursuing IMA approval has significantly declined from the previous market risk regulation.

Supporting FRTB implementation with trusted market data

Despite differences between the EU and US frameworks, both regimes require banks to evidence the availability of real price observations to support Internal Models eligibility and capital calculations. Sourcing such data at scale remains a critical challenge.

LSEG's FRTB Trade Discovery solution is designed to support this requirement by providing access to high quality real price observations across all major asset classes, spanning exchange traded and OTC markets. The solution has been developed in close collaboration with the banking community and is guided by an advisory board that includes six of the world's top ten global banks.

LSEG works with clearing houses, interdealer brokers, trading platforms and trade repositories to source OTC derivatives data across rates, FX, equity and credit markets. This is complemented by data from hundreds of transparent venues, including exchanges and MiFID regulated trading venues, delivering billions of RFET eligible observations.

To support regulatory confidence, the solution is subject to an annual independent external audit, providing assurance that data governance and RFET requirements are met. As a result, banks are better positioned to operationalise the Internal Models Approach and strengthen their competitive positioning as FRTB implementation continues to evolve.

Explore more about how our comprehensive and trusted data keeps you ahead in a shifting regulatory landscape. Regulation doesn't sit still – neither do we.

[Fundamental Review of the Trading Book \(FRTB\) | Data Analytics](#)
