

Deloitte.



Navigating the trading banking book boundary

Balancing risk integrity, practicality
and regulatory intent

September 2025

Introduction

The delineation between the Trading Book (TB) and Banking Book (BB) is a critical component of the market risk capital framework. Under Basel 2.5, this boundary was governed by a principles-based approach, which allowed considerable flexibility in classification and opened the door to regulatory arbitrage.

Basel 3.1 (also referred to as Basel IV), through the Fundamental Review of the Trading Book (FRTB), replaces this with a more prescriptive regime. It introduces strict eligibility criteria, enhanced governance standards and comprehensive documentation requirements to ensure consistent and prudent book designation, while reinforcing the boundary as both an operational and regulatory control.

With increasing product complexity and sophisticated risk-transfer mechanisms, correctly interpreting and implementing the boundary and associated internal risk transfers is both crucial and challenging.



Key interpretations on the Trading–Banking Book Boundary (TBBB)

Building on insights from risk functions across multiple banks, this paper aims to clarify key interpretational points within the prudential regulation.



Key interpretation points



Insights and implications

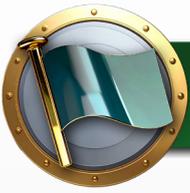
Real Estate Investment Trusts (REITs) and real assets

Direct real estate exposures are assigned to the banking book, whereas indirect exposures via REITs or collective investment vehicles should follow the classification of underlying assets. Where a look-through is possible or daily pricing is available, such instruments may qualify for trading book inclusion under regulatory criteria.

Collective Investment Undertakings (CIUs): “Sufficient and frequent” criteria

CIUs may be classified in the trading book if institutions can perform a look-through to the underlying exposures, provided they meet the regulatory standard of being “sufficient and frequent”. The Prudential Regulation Authority (PRA), under article 132(3)(c)(i) and (ii), clarifies “sufficient and frequent” as follows:

- Information must be available at least quarterly; and
- It must be detailed enough to calculate risk-weighted exposures under the chosen approach (look-through, mandate-based or fallback approach).



Key interpretation points



Insights and implications

Net short positions in the Banking Book (to be capitalised per market risk framework in TB)¹

Net short positions may arise in the banking book due to factors such as credit spread movements (e.g., Credit Default Swap (CDS) gains offsetting bond losses), equity price declines (e.g., In-the-Money put options) or instances of over-hedging. Regulatory standards require that such positions be capitalised under the market risk framework. Given the inherent difficulty in achieving perfectly offsetting hedges, establishing a materiality threshold for the Net Short positions in the Banking Book is considered a prudent approach.

Relevant guidance in the US Notice of Proposed Rulemaking (July 2023) sets a US\$20 million threshold to balance risk sensitivity with operational feasibility.¹

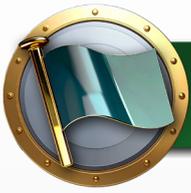
Securities Financing Transactions (SFTs)

SFTs may support trading or liquidity management, and the classification is dependent on intent and valuation. Under the International Financial Reporting Standards (IFRS), fair-valued SFTs with trading intent, such as repos, reverse repos and stock lending, are classified in the trading book.

Conversely, non-fair-valued SFTs used for liquidity management, such as agency stock lending, margin lending and collateral operations, are assigned to the banking book.

The classification hinges on the transaction's intent and valuation treatment.

¹Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity



Key interpretation points



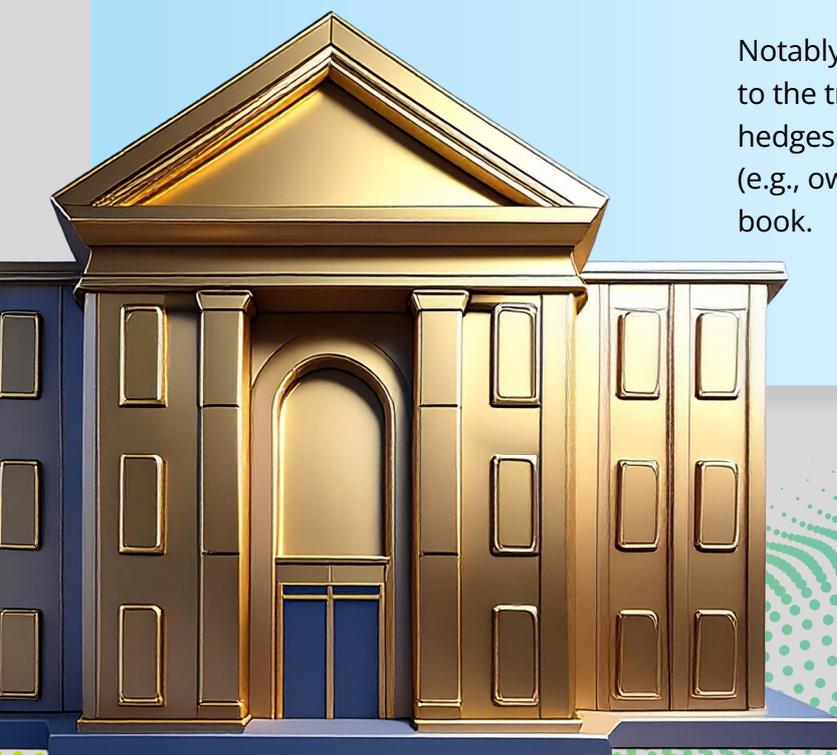
Insights and implications

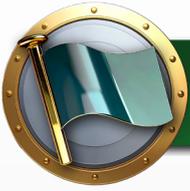
Embedded derivatives

Embedded derivatives are commonly present in instruments such as structured notes, inflation-linked loans and convertible bonds. Prudential rules require the host liability to remain in the banking book, while the embedded derivative is allocated to the trading book. Under IFRS, hybrid contracts are treated using one of two approaches, based on the relationship between the embedded derivative and the funding component:

1. Split accounting applies when the derivative is not closely related to the host. In this case, the host is measured at amortised cost, while the derivative is fair-valued through the Profit and Loss (P&L) account (e.g., equity-indexed loans).
2. The Fair Value Option (FVO) applies when the components are closely related. The entire instrument is fair valued through P&L, with changes in credit risk recorded in Other Comprehensive Income (OCI) (e.g., callable bonds linked to rates).

Notably, internal transfers of embedded derivatives to the trading book are not considered as internal hedges. Moreover, risks unrelated to the derivative (e.g., own credit spread) must remain in the banking book.





Key interpretation points



Insights and implications

Accounting framework influence

Under regulatory standards, securities classified as “held for trading” must be included in the trading book. The definition of “held for trading” aligns with IFRS 9, which requires such instruments to be fair valued through the P&L account. Additionally, instruments designated as Fair Value Through Profit and Loss (FVTPL), even if not held for trading, are also eligible for trading book classification.

Legacy deals

Reclassification to current standards is required, but legacy deals may not trigger capital surcharges retroactively.



Internal Risk Transfers (IRT): Intent, structure and controls

An internal hedge refers to a position that offsets specific risk components between the trading book and one or more banking book positions, or between two trading book positions. To manage such hedges, institutions are required to establish a dedicated IRT desk, subject to explicit regulatory approval. This desk must operate independently and adhere to distinct reporting requirements to ensure transparency and consistency in capital treatment.

Illustrative cases on IRT

CASE 1



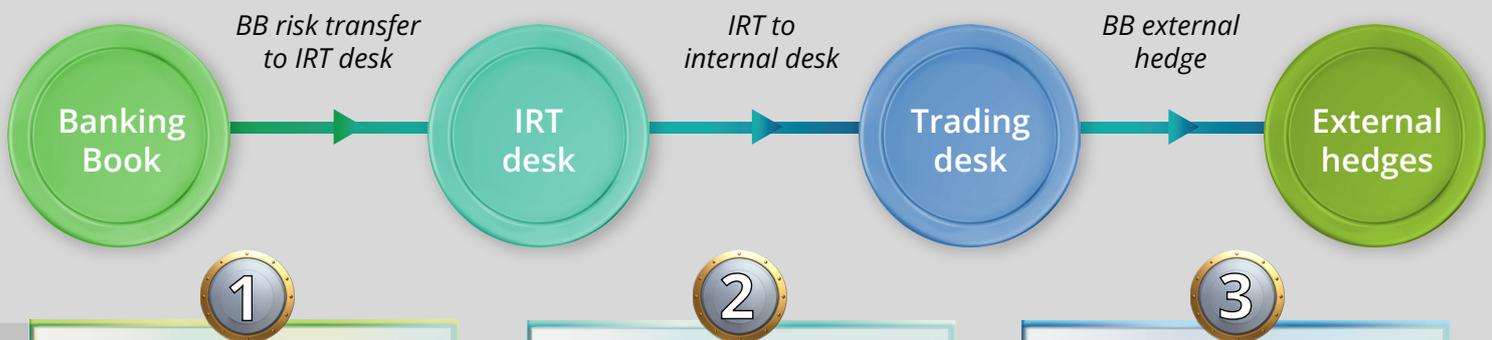
Example

BB instrument:
Fixed-rate loan
Risk: Interest rate risk as banks' funding is linked to a floating rate

IRT transaction:
Fixed-to-floating interest rate swap with IRT desk; IRT desk does a floating-to-fixed swap with the market

Risk recognition:
Banking book: Interest rate exposure is hedged
Trading book: Interest rate risk transferred to an external party via IRT

CASE 2



Example

BB instrument:
Fixed-rate loan
Risk: Default risk from counterparty

IRT transaction: Purchase a Credit Default Swap (CDS) through another trading desk via IRT. The trading desk enters an external hedge with a third party.

Risk recognition:
Banking book: Default risk exposure is hedged
Trading book: Default risk transferred to an external party via IRT

Criteria for IRT and internal hedges



Key interpretation points



Insights and implications

Exact match principle

An exact match requires that internal and external hedging trades be documented under identical terms, with the external position(s), whether singular or aggregated, replicating the full risk profile of the internal hedge. Indicative criteria include notional equivalence, maturity alignment, congruence of risk profiles, consistency in contractual terms and alignment of risk sensitivities.

Over-hedging

If a banking book position is over-hedged through an internal trade, the internal hedge must be reduced to match the exact exposure of the banking book transaction. Any resulting unhedged external position must be allocated to the trading book and capitalised under the market risk capital framework.

Clearing service

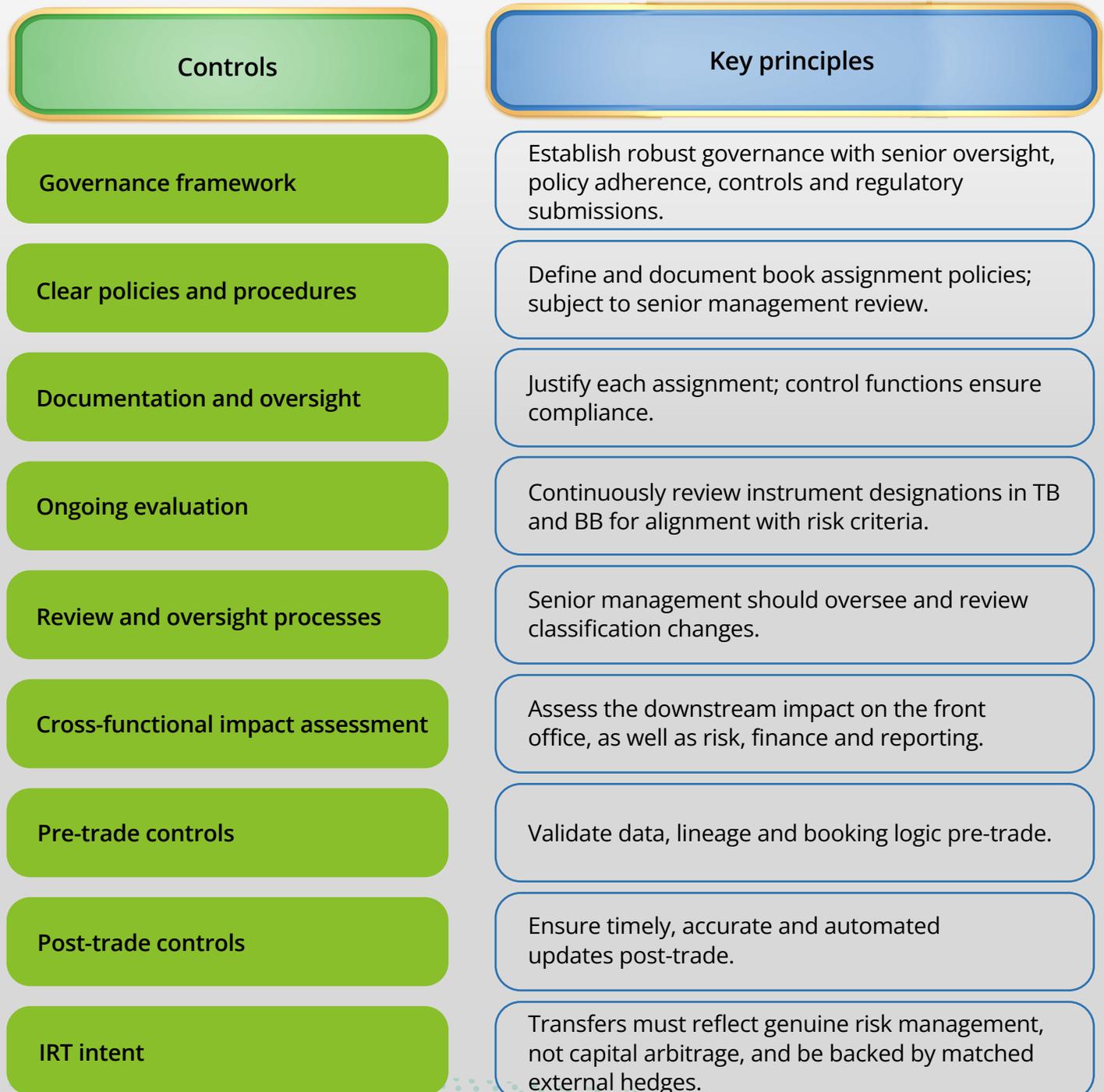
Trades cleared through a Central Counterparty (CCP), for which the bank pays fees, shall not be deemed internal hedges, as their primary purpose is to reduce counterparty risk, not to hedge market exposure.

Internal funding

Internal funding allocations to treasury or individual desks should not be classified as interest rate internal risk transfers, as their primary purpose is liquidity provision, not interest rate risk management.

Establishing a control framework: From policy to practice

Effective implementation of the TBBB and IRT rests on robust governance, reinforced by control layers that span intent, design, execution and oversight.



Conclusion

The regulatory landscape around the TBBB and IRT has matured, yet interpretations vary, and practical implementation remains non-trivial. Institutions must embed the intent of the rules into robust frameworks that are compliant and operationally sustainable.

Establishing well-documented policies, investing in control automation and maintaining a clear audit trail are non-negotiable imperatives for success under Basel 3.1. More importantly, banks must demonstrate that every classification and transfer serves a risk management purpose, not a capital benefit motive.



Connect with us

Nikhil Bedi

Partner and Leader, Risk, Regulatory & Forensic
Strategy, Risk & Transactions
Deloitte India
nikhilbedi@deloitte.com

Asif Lakhani

Partner and Leader, Regulatory & Financial Risk
Strategy, Risk & Transactions
Deloitte India
asiflakhani@deloitte.com

Subrahmanyam Oruganti

Partner, Regulatory & Financial Risk
Strategy, Risk & Transactions
Deloitte India
subrahmanyamo@deloitte.com

Hrishikesh Wattamwar

Executive Director, Regulatory & Financial Risk
Strategy, Risk & Transactions
Deloitte India
hwattamwar@deloitte.com

Contributors

Shekhar Shukla

References

- Minimum capital requirements for market risk
- PS9/24 – Implementation of the Basel 3.1 standards, near-final part 2
- PS17/23 – Implementation of the Basel 3.1 standards near-final part 1
- REGULATION (EU) 2019/876 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 20 May 2019
- REGULATION (EU) 2024/1623 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 31 May 2024



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited (“DTTL”), its global network of member firms, and their related entities (collectively, the “Deloitte organization”). DTTL (also referred to as “Deloitte Global”) and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte Asia Pacific Limited is a company limited by guarantee and a member firm of DTTL. Members of Deloitte Asia Pacific Limited and their related entities, each of which is a separate and independent legal entity, provide services from more than 100 cities across the region, including Auckland, Bangkok, Beijing, Bengaluru, Hanoi, Hong Kong, Jakarta, Kuala Lumpur, Manila, Melbourne, Mumbai, New Delhi, Osaka, Seoul, Shanghai, Singapore, Sydney, Taipei and Tokyo.

This communication contains general information only, and none of DTTL, its global network of member firms or their related entities is, by means of this communication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser.

No representations, warranties or undertakings (express or implied) are given as to the accuracy or completeness of the information in this communication, and none of DTTL, its member firms, related entities, employees or agents shall be liable or responsible for any loss or damage whatsoever arising directly or indirectly in connection with any person relying on this communication.